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In The Supreme Court Of The United States

OCTOBER TERM, 1996

ERNST & YOUNG LLP, PETITIONER

v.

DOLLARD MCGANN, ON BEHALF OF HIMSELF AND ALL OTHERS SIMILARLY SITUATED, ET AL., RESPONDENTS

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit

PETITION FOR A WRIT OF CERTIORARI

MILES N. RUTHBERG
PAMELA S. PALMER
Latham & Watkins
633 West Fifth Street
Suite 4000
Los Angeles, California 90071

KATHRYN A. OBERLY
Counsel of Record
General Counsel
Ernst & Young LLP
787 Seventh Avenue
New York, New York 10019
(212) 733-2500

THOMAS L. RIESENBERG
Associate General Counsel
Ernst & Young LLP
1225 Connecticut Ave., N.W.
Washington, D.C. 20036

Counsel for Petitioner

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QUESTIONS PRESENTED

1. When an outside auditor does nothing more than provide an audit opinion to a client, who then includes it in a routine annual filing with the Securities and Exchange Commission, does the auditor thereby "*use or employ*" the opinion "*in connection with the purchase or sale of any security*" within the meaning of Section 10(b) of the Securities Exchange Act of 1934?

2. Section 18 of the 1934 Act imposes liability on anyone who makes a false statement that is included in an SEC filing and affects the price of stock, but requires plaintiffs to prove *actual reliance* on the false statement. The Ninth Circuit's decision below extends Section 10(b) to impose liability -- *without proof of actual reliance* -- on anyone who makes a false statement that is included in an SEC filing and affects the price of stock. In these circumstances, the question presented is whether the Ninth Circuit's construction of Section 10(b) must be rejected because it nullifies Congress' intent -- embodied in the express language of Section 18 -- to require proof of actual reliance as a limitation upon liability for false statements in SEC filings.

PARTIES TO THE PROCEEDING

The parties to the proceeding in the court of appeals were Ernst & Young LLP; Dollard McGann; Barry A. Bragger; Peter Gershon; Steven G. Cooperman, M.D.; William S. Atherton; Irving Scher, Michael Patitucci, Jr.; J. Floyd Johnson; Schulman, Rogers, Gandal, Pordy & Becker.

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PETITION FOR A WRIT OF CERTIORARI

Ernst & Young LLP respectfully petitions for a writ of certiorari to review the judgment of the United States Court of Appeals for the Ninth Circuit in this case.

OPINIONS BELOW

The amended opinion of the court of appeals (App. at 1a-17a) is pending publication in the official reporter. The opinion of the United States District Court for the Central District of California is unreported (App. at 18a-33a).

JURISDICTION

The judgment of the court of appeals was entered on September 9, 1996 (App. at 1a) and amended on December 4, 1996 (App. at 1a). A timely petition for rehearing and suggestion for rehearing en banc was denied on December 4, 1996 (App. at 3a). This Court's jurisdiction is invoked under 28 U.S.C. § 1254(1).

STATUTES AND RULE INVOLVED

The texts of Sections 9, 10, and 18 of the Securities Exchange Act of 1934 (15 U.S.C. §§ 78i, 78j and 78r), as well as Securities and Exchange Commission Rule 10b-5 (17 C.F.R. § 240.10b-5), are reproduced in the Appendix (App. at 34a-41a).

STATEMENT OF THE CASE

This Court's landmark 1994 decision in *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 114 S.Ct. 1439 (1994), held that there is no liability for aiding and abetting under Section 10(b); liability exists only where "*all* of the requirements for primary liability" are met. *Id.* at 1455. The Ninth Circuit's decision below nullifies an express statutory requirement for primary liability -- *i.e.*, that the defendant "use or employ" fraud "in connection with the purchase or sale of any security" (15 U.S.C. § 78j(b)) -- and does so based upon policy analysis that is irreconcilable with *Central Bank's* mandate that the statutory text and structure of the securities laws control. The issue in this case is whether the Ninth Circuit may circumvent *Central Bank*, and defeat Congress' intent to impose Section 10(b) liability *only* upon those who meet *all* of the requirements for primary liability.

After *Central Bank*, it is pivotal to the proper enforcement of Section 10(b) that the reach of primary liability be defined -- and the distinction between primary and secondary liability be drawn -- as Congress intended. Whether the federal courts will be permitted to extend primary liability beyond the plain text of Section 10(b) is an issue of profound importance to accountants and other professionals who provide services to publicly-traded companies, and who have been the chief targets of aiding and abetting claims -- but not primary liability claims -- under Section 10(b).

A. Factual Background

This is a class action brought on behalf of those who bought common stock of Community Psychiatric Centers ("CPC") in the open market between September 1990 and November 1991. In the last quarter of 1991, after CPC announced charges of approximately $37 million against earnings, the price of CPC stock fell. App. at 4a. Plaintiffs

initially responded with a securities fraud class action naming only CPC and certain corporate insiders. *Id.* at 43a, 45a. Plaintiffs charged the corporation and insiders with a scheme to materially inflate the price of CPC's common stock by falsely portraying the company's finances, earnings, management and future business prospects. *Id.* Plaintiffs alleged that these inside defendants disseminated false statements in news articles, press releases, SEC filings, and comments to analysts so that CPC insiders could reap over $14 million in profits on stock sales before the bad financial news became public. *Id.* at 44a, 46a-50a.

Nearly two years after the original suit was filed, plaintiffs filed this case, a separate, one-count action against Ernst & Young under Section 10(b) and SEC Rule 10b-5. Plaintiffs alleged a single false statement by Ernst & Young, consisting of its audit opinion on CPC's 1990 annual financial statements. *Id.* at 4a, 44a. They alleged that Ernst & Young recklessly or knowingly prepared that opinion and provided it to CPC, knowing that CPC would include the opinion in its annual SEC Form 10-K filing. *Id.* They alleged that, as a result of this publication, the market price of CPC stock was artificially inflated. *Id.* at 4a. On these allegations, plaintiffs charged Ernst & Young with aiding and abetting, conspiracy, and primary violation of Section 10(b) and SEC Rule 10b-5. *Id.*

Plaintiffs did not allege that Ernst & Young engaged in, or had any financial interest in, any securities transaction, or had any purpose or motive to affect any securities transaction; or that its audit opinion was disseminated by CPC in any selling or promotional materials, or that Ernst & Young consented to any such dissemination; or that the opinion was published anywhere other than in CPC's annual report to stockholders and Form 10-K required by SEC regulation.

All public companies are required by Section 13 of the Securities Exchange Act of 1934 to file annual reports "as the

Commission may prescribe." 15 U.S.C. § 78m(2). The SEC has prescribed the filing of annual reports and audited financial statements in a Form 10-K. 17 C.F.R. § 249.310. A Form 10-K is not a stock offering document, like a prospectus, nor does it specifically contemplate sales of securities, like a registration statement. *See* 15 U.S.C. § 78l (stock registration); 15 U.S.C. § 77j (contents of prospectus).

B. The District Court's Decision

In June 1994, two months after this Court held, in *Central Bank*, *supra*, 114 S.Ct. 1439 (1994). that aiding and abetting is not a viable claim under Section 10(b), Ernst & Young moved for judgment on the pleadings. The district court held that the conspiracy claim, like the aiding and abetting claim, was extinguished under the reasoning of *Central Bank*. App. at 28a.

Turning to the primary liability claim, the district court applied *Central Bank*'s holding that "the scope of prohibited conduct under § 10(b) must be determined by looking at the text of the statute and to the express liability provisions of the 1934 Act." *Id.* at 30a. The court concluded that the allegations against Ernst & Young "could not be converted" (*id.*) into a primary violation of Section 10(b):

> [T]he outside auditor, by submitting its November 30, 1990 audit report to its employer, Community Psychiatric Centers, who in [turn] included the report with the Form 10-K filing with [the] Securities and Exchange Commission, cannot be held liable as a primary violator of Section 10(b) . . . for having employed *in connection with the purchase or sale of any security* a manipulative or deceptive device . . . .

Id. at 18a-19a (emphasis in original; citations omitted). Accordingly, the district court granted judgment on the pleadings in favor of Ernst & Young. *Id.*

C. The Ninth Circuit's Decision

The Ninth Circuit reversed. It framed the issue as whether *Central Bank* had "overturned the traditional interpretation of § 10(b) first set forth in *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833 (2d Cir. 1968) (*en banc*), *cert. denied sub nom., Coates v. SEC*, 394 U.S. 976 (1969)." App. at 3a. "In *Texas Gulf*, the Second Circuit held that false and misleading assertions are made 'in connection with' securities trading 'whenever [such] assertions are made . . . *in a manner reasonably calculated to influence the investing public* . . . .' 401 F.2d at 862." *Id.* at 7a (emphasis added). While acknowledging that "[t]he Supreme Court has never squarely addressed the validity of the *Texas Gulf* test," the Ninth Circuit found nothing in *Central Bank*'s analytic approach to undermine that test. *Id.* at 8a-9a.

Applying *Texas Gulf Sulphur*, the Ninth Circuit concluded that *if*, as alleged, Ernst & Young "produced a fraudulent audit report for CPC, knowing that CPC would include this report in its Form 10-K filed with the SEC," then Ernst & Young "made false assertions 'in a manner reasonably calculated to influence the investing public.'" *Id.* at 17a. Because the Ninth Circuit viewed *Texas Gulf Sulphur*'s test as an acceptable substitute for the language of Section 10(b), it deemed the allegations sufficient to plead that Ernst & Young had "use[d] or employ[ed]" fraud "in connection with the purchase or sale" of CPC's securities.

The Ninth Circuit's substantive analysis of Section 10(b)'s "in connection with" requirement consisted entirely of rebuttal to an argument that Ernst & Young never made nor endorsed --that Section 10(b) "limits liability to those who actually trade securities." *Id.* at 10a-16a. The court did not address the analysis that Ernst & Young *did* offer -- that the plain language of Section 10(b) limits liability to defendants who purposefully "use or employ" fraud "in connection with" particular securities

transactions. Nor did the court address compelling legislative history which demonstrates that Congress drafted the express private right of action under Section 18 of the Securities Exchange Act of 1934 to *preclude* liability under precisely the circumstances of this case, where no actual reliance is alleged.

Ernst & Young filed a timely petition for rehearing and suggestion for rehearing *en banc*. On December 4, 1996, the panel denied rehearing but issued an amended opinion adding one sentence which set forth the mental state required for liability under Section 18. App. at 2a. Nothing else was changed.

REASONS FOR GRANTING THE PETITION

The Ninth Circuit's policy-driven construction of Section 10(b) throws a monkey wrench into Congress' integrated regulatory scheme: It deprives the "in connection with" requirement of its plain statutory meaning; it nullifies Congress' intent under Section 18 to limit liability for false statements in SEC filings by requiring proof of actual reliance; and it circumvents this Court's holding in *Central Bank* that liability exists only where "*all* of the requirements for primary liability" are met. 114 S.Ct. at 1455. The decision below thereby creates vast liability exposure -- precisely where Congress intended to *limit* liability -- for accounting and other professionals who merely provide services to publicly-traded companies.

This Court's decision in *Central Bank* was a landmark because it overturned a large, established body of cases that -- like the Ninth Circuit's decision below -- were founded on judicial policy-making that properly resides with Congress. *Central Bank* was a wake-up call to the federal courts to *stop* invoking investor protection rationales to impose more liability than may be found in the plain text of Section 10(b) and structure of the 1933 and 1934 Acts. Ignoring the message of

Central Bank, the Ninth Circuit chose instead to abandon Section 10(b)'s text and to adopt a judicially-crafted substitute in place of the requirement that a defendant "use or employ" fraud "in connection with the purchase or sale of any security." In so doing, the Ninth Circuit reached back thirty years and relied on case law that exalted judicial assumptions about congressional policy over the statutory text.

Only by adopting this policy-driven approach was the Ninth Circuit able to conclude that Ernst & Young "use[d] or employ[ed]" its audit opinion "in connection with the purchase or sale" of securities -- *even though the firm did nothing more than provide an opinion to a client, who then filed the opinion in an annual SEC Form 10-K.* This result conflicts with the intent of Congress by disregarding what the plain statutory language requires -- *that the defendant act purposefully to "use or employ" fraud "in connection with the purchase or sale of any security."* The decision thereby creates two serious errors in the proper enforcement of Congress' statutory scheme.

First, the Ninth Circuit's decision nullifies the remedy expressly provided by Congress in Section 18 (15 U.S.C. § 78r) for investors who rely on false statements in SEC filings. Section 18 requires investors to prove actual reliance. In the absence of actual reliance, the 1934 Congress specifically intended to *preclude* statutory liability where the defendant's only wrong is to make a false statement which is included in an SEC filing and affects the price of stock -- *i.e.*, exactly the claim against Ernst & Young here. The Ninth Circuit's failure to give proper effect to the "in connection with" requirement allows all such cases to be brought under Section 10(b) where no proof of actual reliance is required. This result renders Congress' Section 18 remedy superfluous: It overrides -- in *every* instance -- Congress' intent to make actual reliance a prerequisite to liability based on false statements in SEC filings.

Second, the Ninth Circuit's decision flouts *Central Bank*'s fundamental premise that it is Congress' responsibility to strike the policy balance between too much and too little liability under the federal securities laws. After *Central Bank*, accountants and other professionals who are the natural targets of secondary liability claims may be liable only where "*all* of the requirements for primary liability" are met. 114 S.Ct. at 1455 (emphasis in original). *Central Bank* expressly recognized that broader liability exposure may actually "disserve the goals of fair dealing and efficiency in the securities markets" by overburdening those "who provide services to participants in the securities business" -- such as accountants, lawyers, and bankers. *Id.* at 1454. If the Ninth Circuit and other federal courts may simply side-step the limits of primary liability set forth in the express language of Section 10(b), then *Central Bank* is undercut, and the policy balance struck by Congress is defied.

The Ninth Circuit's decision also exemplifies a broader failure of the federal courts to apply the "in connection with" requirement consistent with the plain text of the statute. This failure leads to striking anomalies in the results of Section 10(b) cases -- as illustrated by comparing this case with *United States v. O'Hagan*, 92 F.3d 612 (8th Cir. 1996), in which the Solicitor General filed a petition for a writ of certiorari on November 26, 1996 (No. 96-842). In *O'Hagan*, the Eighth Circuit deepened an existing circuit split over whether the "in connection with" clause reaches defendants who trade on misappropriated information. The Eighth Circuit held that a defendant -- even though he misappropriated information for the precise purpose of trading in the stock market -- did *not* thereby "use or employ" his act of misappropriation "in connection with the purchase or sale of securities." 92 F.3d at 618. By contrast, the Ninth Circuit below found that Ernst & Young -- who merely issued an audit opinion to a client, who then filed the opinion in its SEC Form 10-K -- *did* "use or

employ" its opinion "in connection with the purchase or sale of securities." Both the Ninth and Eighth Circuits reached these incongruous results by failing to give effect to the plain text of the statute.

In sum, the decision below significantly distorts the proper reach of liability under Section 10(b) and throws Congress' carefully-crafted regulatory scheme out of harmony. As in *Central Bank*, this Court's intervention is needed to set the course straight and refocus the federal courts on text and structure in construing the reach of Section 10(b).

A. The Ninth Circuit's Decision Is Flatly Inconsistent With Supreme Court Authority Governing Construction Of Section 10(b), And Disregards The Plain Language Of The Statute.

1. This Court's landmark decision in *Central Bank* overturned decades of federal cases that erroneously treated aiding and abetting as a valid basis for liability under Section 10(b). *Central Bank*'s unmistakable message was that Section 10(b) liability is defined by Congress wrote, *not* by what courts might believe is good policy. In determining what conduct violates Section 10(b), *first*, "the text of the statute controls." *Id.* at 1446 ("We have refused to allow 10b-5 challenges to conduct not prohibited by the text of the statute."). *Second*, "[w]hen the text . . . does not resolve a particular issue," courts must "attempt to infer 'how the 1934 Congress would have addressed the issue had the 10b-5 action been included as an express provision in the 1934 Act.'" *Id.* at 1448, *quoting Musick, Peeler & Garrett v. Employers Insurance of Wausau*, 508 U.S. 286, 294 (1993).

The Court applied this methodology to the question whether Section 10(b) makes aiding and abetting unlawful. First, the text of Section 10(b) says nothing about aiding and abetting (114 S.Ct. at 1446-48) and "it is inconsistent with

settled methodology in § 10(b) cases to extend liability beyond the scope of conduct prohibited by the statutory text" (*id.* at 1448). Second, Congress did not attach aiding and abetting liability to any of the express liability provisions in the 1933 or 1934 Acts; accordingly, Congress likely would not have attached it to Section 10(b). *Id.* at 1449.

Central Bank's discussion emphasized this Court's consistent rejection of policy-based constructions that "'add a gloss to the operative language of the statute quite different from its commonly accepted meaning.'" *Id.* at 1446. Thus, while "aiding and abetting a wrongdoer ought to be actionable in certain instances," the issue "is not whether imposing private civil liability on aiders and abettors is good policy but whether aiding and abetting is covered by the statute." *Id.* at 1448.[1]

This Court's most recent securities law decision, *Gustafson v. Alloyd Co.*, 115 S.Ct. 1061 (1995), again reaffirmed this text-based analytical approach, and overturned a significant body of case law that had extended liability beyond the text. *Gustafson* held that the term "prospectus" in Section 12(2) of the Securities Act of 1933 (15 U.S.C. §

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[1] This Court's text-based approach goes back at least two decades, starting with *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975), which construed "in connection with" to limit the implied right of action under Section 10(b) to actual buyers and sellers. *Id.* at 733-55. A year later, in *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976), the Court held that Section 10(b) did not reach negligence, declining to read the statute more broadly merely to further the "Congressional purpose . . . to protect investors from false and misleading practices." *Id.* at 198. The following year, in *Santa Fe Industries, Inc. v. Green*, 430 U.S. 462 (1977), the Court held, based on a focused textual reading, that Section 10(b) is not violated by an ordinary breach of fiduciary duty. *Id.* at 472-77. *See also Pinter v. Dahl*, 486 U.S. 622, 653 (1988) (reaffirming that "[t]he broad remedial goals of the Securities Act are insufficient justification for interpreting a specific provision 'more broadly than its language and the statutory scheme reasonably permit.'" Quotations omitted.).

77l(2)) is limited to public offerings and does not reach false statements made in private stock sales. 115 S.Ct. at 1069. The Court emphasized that "limiting language requires a narrow construction." *Id.* at 1070-71. Accordingly, Section 10(b)'s express limitation to defendants who "use or employ" fraud "in connection with the purchase or sale" of securities requires a narrow construction.[2]

2. The question presented in this case parallels the question in *Central Bank* -- *i.e.*, whether particular alleged conduct is made unlawful by the text of Section 10(b) and the structure of the securities acts. Did Ernst & Young -- by merely providing an audit opinion to a client, who then included it in a routine, annual SEC Form 10-K -- thereby "use or employ" the opinion "in connection with the purchase or sale of any security"?[3] The Ninth Circuit did not answer this question by reading the text of Section 10(b), or by considering the reach of the express liability provisions in the securities

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[2] This Court has only twice directly interpreted the "in connection with" clause -- in *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975), and in *Superintendent of Insurance v. Banker's Life and Casualty*, 404 U.S. 6 (1971). Neither of those cases, however, decided what "connection" is required to be a *defendant* under Section 10(b). In *Blue Chip Stamps*, the Court looked at the "connection" necessary to be a *plaintiff*. 421 U.S. at 727. In *Superintendent*, the issue was whether a complex financial fraud was "in connection with" an underlying securities transaction. 404 U.S. at 12. Because both the fraud victim and the defendants were actual participants in the securities transaction (*id.* at 7-8), the case did not present the sufficiency of a defendant's *own* connection with any securities transaction.

[3] The "in connection with" requirement is in addition to the requirement of falsity or fraud. If a party provides *truthful* information that affects the price of stock, the pure "in connection with" question should be the same: Did the party "use or employ" that information "in connection with the purchase or sale of any security"?

laws, as *Central Bank* requires.[4] Rather, the court adopted a judicially-crafted substitute for the "in connection with" language, declaring that it "strikes a reasonable balance" (App. at 9a) and best serves Congress' "'broad remedial goals'" (*id.* at 14a).[5] The court thus concluded that Section 10(b) is violated whenever a defendant makes a false statement "in a manner reasonably calculated to influence the investing public." *Id.* at 16a.

The Ninth Circuit's decision conflicts with every tenet of *Central Bank*, *Gustafson* and their predecessors. It is founded on presumed policy objectives and looks solely at the alleged effect of a defendant's conduct on *investors* -- while disregarding the focus of the statutory text, which is on the *defendant's* connection with the purchase or sale of securities. Under the decision below, anyone can be a defendant under Section 10(b) who does nothing more than make an allegedly false statement that affects the price of stock. Plaintiffs need not prove what the statute requires -- that the defendant

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[4] The Ninth Circuit's discussion of "text" and "structure" missed the mark because it solely addressed an argument that Ernst & Young never made -- that Section 10(b)'s coverage is limited to "actual traders." App. at 10a-16a.

[5] The Ninth Circuit drew its test from the Second Circuit's 1968 opinion in *Texas Gulf Sulphur*. The entire rationale of that decision was to promote investor protection policy goals irrespective of conflict with the statutory text. 401 F.2d at 858-59. The court declared that "*the dominant congressional purposes* of the Exchange Act to protect the investing public" were inconsistent with requiring proof that a defendant either participated in a securities transaction or was motivated to affect stock price. *Id.* at 858-59, 860-61 (emphasis added). The court explicitly exalted policy over text with a quote "relative to an interpretation of the words contained within a congressional statute" (*id.* at 861): "Indeed, at times the purpose [of a congressional statute] may be so manifest as to override even the explicit words used." *Id. Contra Central Bank*, 114 S.Ct. at 1453-54 ("Policy considerations cannot override our interpretation of the text and structure of the Act . . .").

purposefully "use or employ" the false statement "in connection with the purchase or sale of any security."

The Ninth Circuit's policy-driven approach to satisfaction of the "in connection with" requirement dramatically degrades the proof required for a Section 10(b) violation -- and does so most obviously in a fraud-on-the-market case, such as this. Under current law, the fraud-on-the-market doctrine permits plaintiffs to obtain a presumption that satisfies a *separate* element of Section 10(b) liability -- reliance -- merely by showing that an allegedly false statement is made public and affects the price of stock. *Basic Inc. v. Levinson*, 485 U.S. 224, 245-46 (1988) (a 4-2 decision sanctioning the fraud-on-the-market theory in Section 10(b) cases). The Ninth Circuit's construction of the *independent* "in connection with" requirement is indistinguishable: All a plaintiff need show is that the defendant made a false statement that affected the market price of stock.[6] Thus, the Ninth Circuit's interpretation fails to give independent meaning to the "in connection with" language -- even though it is axiomatic that all the words in a statute must be given effect. *Bailey v. United States*, 116 S.Ct. 501, 507 (1995).

3. Applying the first step in *Central Bank*'s analytical approach -- reading the statutory text -- yields a completely different result from the Ninth Circuit's decision below. In Section 10(b), Congress limited liability to defendants who "use or employ" fraud "in connection with the purchase or sale of any security." Under *Gustafson*, this limiting language "requires a narrow construction." 115 S.Ct. at 1071. The verbs "to use or employ" denote purposeful action. *See Bailey*,

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[6] Significantly, when this Court quoted *Texas Gulf Sulphur* in *Basic*, it was *not* with regard to the "in connection with" clause, but rather as part of the Court's discussion of materiality and the fraud-on-the-market doctrine. 485 U.S. at 235 n.13.

supra, 116 S.Ct. at 506 ("various dictionary definitions of 'use' imply action and implementation"). The definite article "*the* purchase or sale of any security" (rather than the indefinite "*a*" or "*any*" purchase or sale) denotes, in ordinary usage, a *particular* securities transaction.

Read plainly, the text of Section 10(b) sets up a purposeful linkage between the defendant's misconduct -- using or employing fraud -- and *particular* securities transactions. In short, Section 10(b) reaches defendants who act purposefully to commit fraud with respect to particular securities transactions. Although this plain reading may reach an accountant who provides false information for use in stock offering or promotional materials, it clearly does not encompass the conduct alleged here -- *i.e.*, providing an audit opinion to a client, who then includes it in the client's routine annual regulatory report to the SEC.[7]

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[7] Two recent decisions exemplify this distinction. In *Anixter v. Home Stake Production Company*, 77 F.3d 1215, 1229 (10th Cir. 1996), the Tenth Circuit found sufficient evidence of an auditor's primary liability under Section 10(b) where the auditor participated in preparing and filing sales program books, prospectuses, and registration statements (*id.* at 1219), and his "opinions and decertification letters were reproduced in . . . other [client] promotional material." *Id.* at 1227. This conduct reflects *purposeful action* with respect to *particular* securities transactions. On the other hand, in *Frymire-Brinati v. KPMG Peat Marwick*, 2 F.3d 183 (7th Cir. 1993), the Seventh Circuit rejected any conclusion that because an accounting firm perhaps "should have known" that its client would sell stock using financial information provided by the firm, the firm thereby provided the information "in connection with the purchase or sale of any security." *Id.* at 190. The court recognized that clients use financial information for a host of purposes, not all of which are to induce the purchase or sale of securities (*id.*). It is too much a leap to infer that because an auditor knows that a client will use an audit opinion to meet SEC regulatory reporting requirements, the auditor thereby uses the opinion "in connection with the purchase or sale" of the client's securities.

B. The Ninth Circuit's Policy-Driven Construction Of Section 10(b)'s "In Connection With" Requirement Nullifies Congress' Express Remedy Under Section 18 And Conflicts With Other Provisions Of The 1934 Act.

1. The second step in *Central Bank*'s analytical approach is to infer how Congress "`would have addressed the issue had the 10b-5 action been included as an express provision in the 1934 Act'" using "the express causes of action in the securities Acts as the primary model." 114. S.Ct. at 1448, *quoting Musick, Peeler, supra.* The purpose of this analysis is to ensure that the judicially-created private right of action under Section 10(b) "does not conflict with Congress' own express rights of action." *Musick, Peeler*, 508 U.S. at 295.

The Ninth Circuit's construction of "in connection with," as applied in this case, runs headlong into conflict with Section 18 of the 1934 Act. There, Congress created an express, private right of action for precisely the conduct with which Ernst & Young stands charged: Section 18 provides a remedy for investors who rely on allegedly false statements, made in SEC filings, that affect the price of stock. Section 18 states, in relevant part:

> Any person who shall make or cause to be made any statement in any . . . document filed pursuant to this chapter or any rule or regulation thereunder . . . which statement was . . . false or misleading with respect to any material fact, shall be liable to any person (not knowing that such statement was false or misleading) who, in reliance upon such statement, shall have purchased or sold a security at a price which was affected by such statement . . . unless the person sued shall prove that he acted in good faith and had no knowledge that such statement was false or misleading. 15 U.S.C. § 78r.

Liability under Section 18, as under Section 10(b), is limited to defendants who act with scienter. *Musick, Peeler, supra*, 508 U.S. at 296; *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 209 n. 28, 211 n. 31 (1969).[8] While creating a cause of action in Section 18 for false SEC filings that affect the price of stock, however, Congress decided to include an important limitation -- *actual reliance* -- meaning that the plaintiff must actually read and rely upon the false statement. No such limitation is expressed in the text of Section 10(b).[9]

Given that Section 18 is the remedy expressly provided by Congress for false statements in SEC filings, liability under Section 10(b) cannot be so broad that it nullifies the reliance requirement of Section 18. *See Ernst & Ernst, supra*, 425 U.S. at 208-11 (Section 10(b)'s scienter requirement is necessary to avoid nullifying Congress' "carefully drawn" restrictions on express private rights of action for negligent misconduct). But this is precisely what the Ninth Circuit's decision does: It extends Section 10(b) liability to cover any false statement that foreseeably becomes public and affects the price of stock. Thus, *every* allegedly false statement made in an SEC filing automatically satisfies the Ninth Circuit's test and gives rise to a Section 10(b) action. This result renders the Section 18 remedy superfluous and leaves *no* instance in which a defendant's liability for making a false statement in an SEC filing would be limited by Section 18's actual reliance requirement. *See Bailey, supra*, 116 S.Ct. at 507 (courts must

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[8] Under Section 18, proof of a false statement makes a *prima facie* case; the defendant can avoid liability by showing good faith and ignorance of the falsity. *Id.* Thus, negligent statements made in good faith do not give rise to Section 18 liability; rather, intentional or reckless misconduct is required.

[9] Under prevailing law, reliance generally may be presumed under Section 10(b) -- but not Section 18 -- when a material misrepresentation affects the price of stock in the open market. *See Basic, supra*, 485 U.S. at 245-46.

avoid an interpretation of a statute that renders any part superfluous).

If, however, Section 10(b)'s "in connection with" clause is given appropriate meaning, then Section 10(b) and Section 18 are harmonized: At least *some* defendants who make false statements in SEC filings will have no liability under Section 10(b) (because they lack the "connection") but will have liability under Section 18 (because no "connection" is required), assuming the plaintiff can prove actual reliance. This outcome would preserve Congress' intent to make actual reliance a meaningful limitation on liability under Section 18.[10]

In *any* event, the legislative history of Section 18 provides dispositive evidence that Congress intended to *preclude* statutory liability under the fact scenario alleged *here*. Section 18, as originally drafted, had *no* actual reliance requirement and provided for recovery by any plaintiff "who shall have purchased or sold a security the price of which may have been affected by such [misleading] statement." S. 2693, 73d Cong., 2d Sess. § 17(a) (1934), H.R. 7852, 73d Cong., 2d Sess. § 17(a) (1934). Thus, the original version of Section 18 created liability for precisely the conduct at issue here: where a defendant does nothing more than provide allegedly fraudulent information in an SEC filing which affects the price of stock. This, of course, is the very conduct for which the Ninth Circuit would impose liability under Section 10(b) -- even though

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[10] By overextending the reach of Section 10(b), the Ninth Circuit's construction actually strengthens the argument that Section 18 should be deemed the *exclusive* remedy for false statements filed with the SEC. This Court expressly has reserved the issue whether Section 18 is an exclusive remedy, noting that "[t]here is evidence to support the view that § 18(a) was intended to provide the exclusive remedy for misstatements contained in any reports filed with the Commission . . . ." *Touche Ross & Co. v. Redington*, 442 U.S. 560, 573 (1979). *See also Ernst & Ernst*, 425 U.S. at 211 n. 31.

Congress amended Section 18 to explicitly and unequivocally *reject* liability on this basis.

The original version of Section 18 drew protest from those who argued that defendants -- including the accountants and other professionals principally targeted by Section 18[11] -- were overexposed to liability. In response, Congress added *actual reliance* as a prerequisite to liability.[12] Congress *cannot* have meant to allow the very claim that it rejected under Section 18 to be viable under Section 10(b). This shows, in and of itself, that the Ninth Circuit's construction of "in connection with" is inconsistent with Congress' regulatory scheme.

2. This analysis is only fortified by reviewing Section 10(b) in the context of its statutory neighbors, Sections 9 and 10(a). *See Musick, Peeler, supra*, 508 U.S. at 296 (describing Sections 9, 10, and 18 as the closest analogues in the 1934 Act). Section 10(b) follows a series of provisions in the 1934 Act, running from Section 9(a) through Section 10(a), all of which make specific trading activity unlawful, absent compliance with SEC regulations -- from puts, calls, straddles, options, swaps, and matched trades in Section 9(a) to short

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[11] Congress' focus on the accounting profession under Section 18 was signaled in an earlier House draft which expressly applied to "any person (including any director or officer, or *any accountant or expert*) who shall make or cause to be made any [false] statement in any application, report, or document filed pursuant to this Act." H.R. 9323, 73d Cong., 2d Sess. § 17(a) (1934) (emphasis added). Congress then debated the liability of accountants and other experts under Section 13 (15 U.S.C. § 78m), concerning regulatory reporting requirements, and Section 18 (the related civil liability provision) (78 Cong. Rec. 8040 (1934)), but the accounting profession was not mentioned in the debate concerning Section 10(b).

[12] Representative Rayburn, sponsor of the House Bill, introduced the revisions, commenting that the "the first provision of the bill as originally written was very much challenged on the ground that reliance should be required. This objection has been met." 78 Cong. Rec. 7701 (1934).

sales and stop loss orders in Section 10(a). All of these provisions regulate the conduct of defendants who are actively involved in the trading process. Read in context, Section 10(b) gives the SEC authority to regulate fraudulent trades and trading practices not listed in Sections 9(a) through 10(a) -- *i.e.*, *new* manipulative and deceptive practices that might spring from the creative imaginations of financial swindlers.

While Section 10(b) is not limited to active participants in the trading process -- unlike Sections 9(a) through 10(a) -- it is part of a regulatory scheme that clearly targets active traders. Section 10(b)'s placement in this scheme is consistent with the plain reading that liability is limited to defendants who *take purposeful action with respect to particular securities transactions*. *See* discussion, *supra*, at 13-14. This reading is supported by the legislative history in which Section 10(b) is described as a "catch-all." This Court quoted that history in *Ernst & Ernst*:

> The most relevant exposition of the provision that was to become §10(b) was by Thomas G. Corcoran, a spokesman for the drafters. Corcoran indicated:
>
> > Subsection (c) [referring to §9(c) of H.R. 7852 that was to become §10(b)] says, "Thou shalt not devise any *other* cunning devices." . . . *Of course subsection 9(c) [to become § 10(b)] is a catch-all clause to prevent manipulative devices.* I do not think there is any objection to that kind of clause. *The Commission should have the authority to deal with new manipulative devices.*" Hearings on H.R. 7852 and H.R. 8720 before the House Committee on Interstate and Foreign Commerce, 73d Cong., 2nd. Sess. 115 (1934).'

425 U.S. at 202-03 (emphasis added).

In describing Section 10(b) as a "catch-all" to deal with new manipulative devices, Congress' focus was on capturing different kinds of frauds that were not expressly listed in the statutory provisions regulating actual participants in the trading process.[13] While, again, Section 10(b) is not limited to traders, its statutory context and legislative history logically preclude a construction of the "in connection with" requirement that *wholly* disregards the defendant's own role in any securities transaction. Yet, this is exactly what the Ninth Circuit's decision does: The defendant need not have any purpose, interest, motive, or relationship of *any* kind with *any* particular securities transaction. This result is patently inconsistent with Section 10(b)'s place in Congress' regulatory scheme.

C. The Ninth Circuit's Decision Significantly Undermines *Central* Bank's Holding That Section 10(b) Liability Is Limited To Primary Wrongdoers.

In *Central Bank*, this Court reaffirmed that it is *Congress'* responsibility to enact laws that strike the proper policy balance between too much and too little liability; it is the *courts'* responsibility to interpret the intent of Congress based on the text and structure of those laws. Congress struck that balance in Section 10(b) by limiting liability to primary

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[13] Similarly, Mr. Landis – Chairman of the Federal Trade Commission which was charged with administering the Securities Act of 1933 before creation of the SEC in the 1934 Act – described what was to become Section 10(a) as setting forth "important powers" of the SEC to regulate short selling and stop loss orders, and described Section 10(b) as giving "the general power to the Commission to prescribe the rules and regulations governing any *other* manipulative devices." Hearing on H.R. 7852 and H.R. 8720 before the House Committee on Interstate and Foreign Commerce, 73d Cong., 2d Sess. 21 (1934) (emphasis added). *See also* S. Rep. No. 792, 73d Cong., 2d Sess. 18 (1934) (describing § 10(b) as authorizing the SEC to regulate "the use of *other* manipulative or deceptive practices"; emphasis added).

wrongdoers. 114 S.Ct. at 1449. This Court made clear that, after *Central Bank*, accountants, lawyers, bankers, and other traditional targets of secondary liability claims "may be liable as [] primary violator[s] under 10b-5" *only* if "*all* of the requirements for primary liability" are met. *Id.* at 1455 (emphasis in original).

The Ninth Circuit's decision undermines this result by doing exactly what *Central Bank* exhorts the federal courts *not* to do -- invoking policy to extend liability beyond the limits of Section 10(b)'s text and statutory structure. This result erodes the proof required for a primary violation and, by over-extending liability, disregards the policy balance that Congress drew.

This case was filed against Ernst & Young on facts sufficient to allege aiding and abetting: The essence of the case is that Ernst & Young's audit opinion helped CPC's insiders violate Section 10(b) by reaping a profit on stock trades prior to public disclosure of CPC's financial problems. App. at 46a-47a. Although plaintiffs also asserted a primary violation against Ernst & Young, it made no difference before *Central Bank* whether there were allegations to support it. But *Central Bank* made the distinction between primary and secondary liability pivotal. The Ninth Circuit's decision erodes that distinction by nullifying an important element of primary liability specified by Congress.

If Ernst & Young could fairly be said to "use or employ" fraud "in connection with the purchase or sale of any security," then primary liability should follow. But no reader coming freshly upon Section 10(b) could reasonably interpret that provision to reach the conduct at issue here: As a matter of law, auditors are not subject to the federal securities laws and rules requiring periodic disclosures to the SEC -- their clients are (15 U.S.C. § 78m); it is the client who decides what information to make public; it is the client who determines the

contents of the regulatory 10-K; and it is the client on whose behalf the 10-K is filed. The auditor's job is to conduct an audit of the client's financial statements, prepare a report, and submit it to the client -- who then may use it for a multitude of business purposes, including regulatory compliance. *See Frymire*, *supra*, 2 F.3d at 190.[14] This is the essence of secondary conduct, yet the Ninth Circuit turns it into primary liability under Section 10(b) by failing to require any purposeful linkage between the auditor's conduct and the purchase or sale of any security.

Although the Ninth Circuit improperly invoked investor protection policy to bring the mere preparation of an audit report within the reach of Section 10(b), the court did *not* thereby assure that "the objectives of the statute are better served." *Central Bank*, *supra*, 114 S.Ct. at 1454. To the contrary, *Central Bank* expressly recognized that when federal courts invoke investor protection policy to expand Section 10(b) liability, the "ripple effects" of broad liability exposure upon "those who provide services to participants in the securities business" may "disserve the goals of fair dealing and efficiency in the securities markets." *Id.* In particular, the costs and risks of securities litigation to outside professionals -- notably accounting firms -- may lead to higher costs of professional services which are passed on to investors, and may

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[14] Moreover, unlike corporations and insiders, auditors do not have any financial stake in the value of the corporation's securities. The SEC will not recognize an accountant as qualified to opine on financial statements unless the accountant is "independent" -- a term defined by a lack of "any direct financial interest or any indirect material financial interest" in the client. 17 C.F.R. § 210.2-01(b) ("Qualifications of Accountants"). *See also* Codification of Accounting Standards and Procedures, Statement on Auditing Standards No. 1, § 220 (Am. Inst. of Certified Pub. Accountants 1988) (defining "independence").

lead also to a scarcity of professional services for companies and investors that need them the most. *Id.*[15]

As this Court has made abundantly clear, Section 10(b) was never meant to reach *all* conduct that might be deemed wrongful and affect investors. If Ernst & Young prepared a fraudulently misleading audit report, then Section 18 and the common law both supply causes of action of which investors may avail themselves. The Ninth Circuit should not be permitted to undermine *Central Bank* by creating additional liability where none was intended by Congress.

D. The Federal Courts Do Not Apply The "In Connection With" Requirement Consistently.

The Ninth Circuit is not the only federal court to continue to invoke policy -- even after *Central Bank* -- to distort the plain meaning of the "in connection with" requirement.[16] Comparing the incongruous results of this case and another "in connection with" case in which a certiorari petition is pending shows that there is something fundamentally wrong and inconsistent in how federal courts apply this statutory requirement. This situation should not be tolerated in "an area

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[15] This Court has expressly recognized the reality that "in the field of federal securities laws governing disclosure of information even a complaint which by objective standards may have very little chance of success at trial has a settlement value to the plaintiff out of any proportion to its prospect of success at trial . . . ." *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 740 (1975). Thus, litigation under Section 10(b) "`presents a danger of vexatiousness different in degree and in kind from that which accompanies litigation in general.'" *Central Bank*, 114 S.Ct. at 1454, *quoting Blue Chip Stamps, supra.*

[16] *See, e.g., Itoba Ltd v. Lep Group PLC*, 54 F.3d 118 (2d Cir. 1995), *cert. denied*, 116 S.Ct. 702 (1996) (post-*Central Bank*); *Akin v. Q-L Investments, Inc.*, 959 F.2d 521 (5th Cir. 1992) (pre-*Central Bank*). If past is prologue, there is little reason to believe that the federal courts will abandon their misguided reliance on policy considerations absent this Court's intervention.

[of securities law] that demands certainty and predictability." *Central Bank*, 114 S.Ct. at 1544, *quoting Pinter v. Dahl*, 486 U.S. 622, 652 (1988).

The United States is seeking review in *O'Hagan*, where the Eighth Circuit deepened a circuit split by holding that the misappropriation theory of liability is not viable under Section 10(b). *See* Petition at 14-15, United States v. O'Hagan (No. 96-842). In that case, a defendant lawyer misappropriated information that a client of his firm was contemplating a tender offer for the stock of a target company. 92 F.3d at 614. Using that information, he bought options in the target company's stock and made nearly $4.1 million when the tender offer was publicly announced. *Id.*

Relying in part on the "in connection with" clause, the Eighth Circuit reversed the defendant's conviction under Section 10(b): Even though the defendant used misappropriated information for the precise purpose of trading in the stock market, the Eighth Circuit concluded that he nonetheless did *not* "use or employ" his act of misappropriation "in connection with the purchase or sale of securities" under Section 10(b). *Id.* at 618. By contrast, here, where Ernst & Young took no purposeful action at all with respect to any securities transaction, but only provided an audit opinion to its client, the Ninth Circuit found that Ernst & Young *did* allegedly "use or employ" its opinion "in connection with the purchase or sale of securities."

Both the Eighth Circuit and the Ninth Circuit reach these anomalous results by disregarding Section 10(b)'s clear focus on *the defendant*'s purpose to use or employ fraud in connection with a particular securities transaction. Indeed, the Solicitor General argues that the Eighth Circuit's decision is wrong because "*[t]he [defendant's] trading* on the misappropriated information establishes that the fraud is committed 'in connection with' the purchase or sale of

securities." Petition, *supra*, at 13 (emphasis added). But in the view of the Ninth Circuit below -- and the Eighth Circuit in *O'Hagan* -- the defendant's own purpose with respect to any securities transaction has little or nothing to do with satisfying "the connection." *See O'Hagan*, 92 F.3d at 618; App. at 16a-17a.

If both the Eighth and Ninth Circuits had read Section 10(b) plainly to reach defendants who act purposefully to "use or employ" fraud "in connection with the purchase or sale of any security" then the results of the two cases -- based at least on this element of liability -- would be inverted: The defendant in *O'Hagan* would face Section 10(b) liability and Ernst & Young would not. These conflicting and anomalous results underscore the importance of this Court's intervention and guidance on the crucial question of the "connection" necessary to be a defendant under Section 10(b).

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted.

MILES N. RUTHBERG
PAMELA S. PALMER
Latham & Watkins
633 West Fifth Street
Suite 4000
Los Angeles, California 90071

KATHRYN A. OBERLY
Counsel of Record
General Counsel
Ernst & Young LLP
787 Seventh Avenue
New York, New York 10019

THOMAS L. RIESENBERG
Associte General Counsel
Ernst & Young LLP
1225 Connecticut Ave., N.W.
Washington, D.C. 20036

Counsel for Petitioner

JANUARY 1997

APPENDICES

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UNITED STATES COURT OF APPEALS,
NINTH CIRCUIT.

AMENDED OPINION SECURITIES

DOLLARD MCGANN; BARRY A. BRAGGER;
PETER GERSHON; STEVEN G. COOPERMAN, M.D.;
WILLIAM S. ATHERTON; IRVING SCHER;
MICHAEL PATITUCCI, JR.;
J. FLOYD JOHNSON; SCHULMAN,
ROGERS, GANDAL, PORDY & BECKER, et al.,
Plaintiffs-Appellants,

v.

ERNST & YOUNG,
Defendant-Appellee.

No. 95-55925
D.C. No. CV-93-00814-AHS,
CV-93-00914-AHS
United States Court of Appeals
Ninth Circuit
Filed December 4, 1996

Appeal from the United States District Court for the
Central District of California Alicemarie H. Stotler,
District Judge, Presiding
Argued and Submitted August 7, 1996--
Pasadena, California
Filed September 9, 1996

Before: BETTY B. FLETCHER, A. WALLACE TASHIMA, Circuit Judges, and JANE A. RESTANI,* Judge, United States Court of International Trade.

Opinion by: Judge Fletcher.

COUNSEL

Leonard B. Simon, Milberg, Weiss, Bershad, Hynes & Lerach, San Diego, California, for the plaintiffs-appellants.

Miles N. Ruthberg, Latham & Watkins, Los Angeles, California, for the defendant-appellee.

Richard H. Walker, Securities and Exchange Commission, Washington, D.C., for the amicus curiae.

ORDER

The opinion filed September 9, 1996 is amended as follows:

At Slip op. 11550, after the citatica to *Ross v. A.H. Robins Co.* insert the following:

> A defendant has available to it an affirmative defense that it acted in good faith and had no knowledge that its statement was false or misleading. *Musick, Peeler and Garrett v. Employers Ins. of Wausau*, 508 U.S. 286, 296 (1993), (noting ¶ 18 involves defendants who violated securities law with scienter, citing to *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 209, n.28 (1975)).

With this correction, the panel as constituted in the above case has voted to deny the petition for rehearing.

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* Honorable Jane A. Restani, Judge of the United States Court of International Trade, sitting by designation.

Judges Fletcher and Tashima have voted to deny the suggestion for rehearing en banc and Judge Restani so recommends.

The full court has been advised of the suggestion for rehearing en banc and no judge of the court has requested a vote on it. Fed. R. App.P.35(b).

The petition for rehearing is denied and the suggestion of rehearing en banc is rejected.

FLETCHER, Circuit Judge:

Plaintiff securities investors appeal the grant of judgment on the pleadings for defendant Ernst & Young ("E&Y"), an independent accounting firm. Plaintiffs alleged that E&Y incurred primary liability under § 10(b) of the Securities Exchange Act of 1934 (the "Act") by preparing a fraudulent audit report that it knew would be included by its client in a Form 10-K. This case requires us to decide whether the Supreme Court's recent decision in *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, ___ U.S. ___, 114 S. Ct. 1439 (1994), overturned the traditional interpretation of § 10(b) first set forth in *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833 (2nd Cir. 1968) (en banc), *cert. denied sub nom. Coates v. SEC*, 394 U.S. 976 (1969). We have jurisdiction 28 U.S.C. § 1291, and we reverse.

I. FACTS AND PRIOR PROCEEDINGS

At all relevant times, E&Y was the outside auditor for the Community Psychiatric Centers ("CPC"), a publicly traded corporation, Plaintiffs alleged the following facts: E&Y issued a false and misleading audit opinion regarding CPC's financial statements for the fiscal year ending in November 1990. Specifically, E&Y failed to disclose the fact that CPC had a major accounts receivable problem. E&Y knew that CPC would include this audit opinion in its annual Form 10-K filed with the Securities and Exchange Commission ("SEC"). The

suppression of this information caused the artificial inflation of the price of CPC's stock. In September and November 1991, when CPC announced a major drop in earnings due to $37 million in uncollectible debts, the value of CPC's stock declined precipitously.

In June 1993, plaintiffs filed this action against E&Y.[1] Plaintiffs are a class of persons who purchased CPC stock between the time of the publication of E&Y's audit opinion and the time of CPC's announcement regarding bad debts. Plaintiffs alleged that by producing a fraudulent audit report with the knowledge that its client would disseminate the statements therein to the securities market, E&Y committed fraudulent acts "in connection with" the trading of securities, 15 U.S.C. § 78j(b), and thus violated § 10(b). Plaintiffs claimed that E&Y was both a primary violator as a conspirator with and an aider and abettor to CPC.

In May 1995, the district court granted E&Y's motion for judgment on the pleadings. *See* Fed. R. Civ. P. 12(c). The court held that the Supreme Court's recent decision in *Central Bank* squarely rejected aider and abettor liability under § 10(b). The court also held that *Central Bank* implicitly rejected conspirator liability.[2] The plaintiffs appeal neither of these holdings.

The district court then dismissed the plaintiffs' primary liability claim, holding that an independent accounting firm does not act "in connection with" securities trading when it produces a fraudulent audit report that it knows its client will include in a Form 10-K. The court noted the contrary

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[1] Plaintiff's separate action against CPC, McGann v. Community Psychiatric Centers, D.C. No. CV-91-533, has settled.

[2] The Ninth Circuit subsequently held that the rationale of Central Bank "precludes a private right of action [under § 10(b)] for 'conspiracy' liability." In re Glenfeld, Inc. Securities Litigation, 60 F.3d 591, 592 (9th Cir. 1995).

authority of the Second Circuit's *Texas Gulf* and the Ninth Circuit's *Wessel v. Buhler*, 437 F.279 (9th Cir. 1971), but concluded that the these decisions were inconsistent with *Central Bank*. Specifically, the court reasoned that while *Central Bank* rested on the text of § 10(b), *Texas Gulf* and *Wessel* improperly rested on underlying congressional goals. The plaintiffs appeal the district court's primary liability holding.

II. DISCUSSION

This case presents two overlapping questions: First, did *Central Bank* undermine *Texas Gulf* and its progeny? Second, is an accounting firm subject to primary liability under § 10(b) when it prepares a fraudulent audit report that it knows its client will include in a Form 10-K? We answer the first question in the negative, and the second question in the affirmative.

A. STANDARD OF REVIEW

We review de novo a judgment on the pleadings pursuant to Rule 12(c). *Merchants Home Delivery Service, Inc. v. Hall & Co.*, 50 F.3d 1486, 1488 (9th Cir.) (citation omitted), *cert. denied sub nom. Prometheus Funding Corp. v. Merchants Home Delivery Service, Inc.*, ___ U.S. ___, 116 S. Ct. 418 (1995). A judgment on the pleadings is properly granted when, taking all allegations in the pleading as true, the moving party is entitled to judgment as a matter of law. *Id.* We also review questions of law de novo. *Twenty-Three Nineteen Creekside, Inc. v. Commissioner*, 59 F.3d 130, 131 (9th Cir. 1995).

B. THE TRADITIONAL VIEW: *TEXAS GULF*

The Securities Exchange Act of 1934 regulates the postdistribution trading of securities. *See* 15 U.S.C. § 78a et seq. The "'fundamental purpose'" of the Act was "'to substitute a philosophy of full disclosure for the philosophy of

caveat emptor.'" *Central Bank*, 114 S. Ct. at 1445 (quoting *Affiliated Ute Citizens of Utah v. United States*, 406 U.S. 128, 151 (1972)). Section 10(b) of the Act prohibits fraudulent activities "in connection with" the purchase or sale of securities,[3] as does SEC Rule 10b-5.[4]

In *Texas Gulf*, the Second Circuit held that false and misleading assertions are made "in connection with" securities trading "whenever [such] assertions are made. . . in a manner reasonably calculated to influence the investing public . . . ." 401 F.2d at 862. Specifically, the court held that company officers violated Rule 10b-5 by issuing a misleading press release regarding the company's successful oil exploration activities. The court further held that the prohibition of Rule

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[3] Section 10(b) of the Act provides: It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange. . .

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the [SEC] may prescribe as necessary or appropriate in the public interest or for the protection of investors. 15 U.S.C. § 78j (emphasis added).

[4] SEC Rule 10b-5 provides: It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

(a) To employ any device, scheme, or artifice to defraud,

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

17 CFR § 240.10b-5 (1993) (emphasis added).

10b-5 applies whether or not "the makers of a misleading statement also participated in pertinent securities transactions in connection therewith . . . ." *Id.* at 860. *See also Heit v. Weitzen*, 402 F.2d 909 (2nd Cir. 1968) (applying *Texas Gulf* to fraudulent annual reports, "as well as documents filed by the individual defendants with the SEC"), *cert. denied*, 395 U.S. 903 (1969).

The Ninth Circuit adopted the Second Circuit's formulation. In *Wessel*, the Ninth Circuit held that" 'Rule 10b-5 is violated whenever assertions are made . . . . in a manner reasonably calculated to influence the investing public. . . .'" 437 F.2d at 282 (quoting *Texas Gulf*, 401 F.2d at 862). The court then held that an outside accountant does not violate this standard by preparing documents that were never publicly disseminated. *Id.* In *SEC v. Rana Research, Inc.*, 8 F.3d 1358 (9th Cir. 1993), the Ninth Circuit again relied on the *Texas Gulf* formulation, holding that a financial consultant violated Rule 10b-5 by issuing a misleading press release regarding the stock value of a publicly traded company. *Id.* at 1362.

Several other circuits have also adopted *Texas Gulf*'s interpretation of the "in connection with" language of § 10(b). *Gottlieb v. Sandia American Corp.*, 452 F.2d 510, 516 (3rd Cir.), *cert. denied sub nom. Weschler v. Gottlieb*, 404 U.S. 938 (1971); *Akin v. Q-L Investments, Inc.*, 959 F.2d 521, 528 (5th Cir. 1992); *Mitchell v. Texas Gulf Sulphur Co.*, 446 F.2d 90, 100-01 (10th Cir.), *cert. denied*, 404 U.S. 1004 (1971); *SEC v. Savoy Industries, Inc.*, 587 F.2d 1149, 1171 (D.C. Cir. 1978), *cert. denied sub nom. Zimmerman v. SEC*, 440 U.S. 913 (1979).

The Supreme Court has never squarely addressed the validity of the *Texas Gulf* test. *See Superintendent of Ins. of the State of New York v. Bankers Life & Cas. Co.*, 404 U.S. 6, 1213 (1971) (describing the issue as whether deceptive practices "touch[ ]" the sale of securities). However, in a

discussion of the materiality of merger discussions for the purposes of § 10(b), the Court favorably quoted *Texas Gulf*'s interpretation of the "in connection with" language. *Basic Inc. v. Levinson*, 485 U.S. 224, 235 n.13 (1988).

C. THE CONTINUED VITALITY OF TEXAS GULF

The district court held and the defendant argues on appeal that *Central Bank* fatally undermined *Texas Gulf* and its progeny. Specifically, it is claimed that while the former requires an analysis of the text and structure of § 10(b), the latter improperly rest exclusively on policy considerations. The defendants further argue that under a proper reading of "in connection with" only those who actually trade securities are subject to primary liability under § 10(b). Accountants who simply make misrepresentations that they know will be included in Forms 10-K would not be included.

These reports of *Texas Gulf*'s demise are greatly exaggerated. There is no tension between the holding of *Central Bank* and the holding of *Texas Gulf*: the former forbids § 10(b) actions against aiders and abettors, 114 S. Ct. at 1455, while the latter allows § 10(b) actions against primary violators "whenever assertions are made . . . in a manner reasonably calculated to influence the investing public . . . ." *Wessel*, 437 F.2d at 282 (quoting *Texas Gulf*, 401 F.2d at 862). Indeed, while *Texas Gulf* turned on the meaning of "in connection with," *Central Bank* turned instead on the fact that "the text of the 1934 Act does not itself reach those who aid and abet a § 10(b) violation." 114 S. Ct. at 1448.

Nor does the analytic approach of *Central Bank* undermine *Texas Gulf*'s interpretation of the "in connection with" language of § 10(b).

1. Textual Analysis

The *Central Bank* Court began with an analysis of the text of § 10(b). 114 S. Ct. at 1445-48. *See Federal Trade Comm'n v. Bunte Bros., Inc.*, 312 U.S. 349, 350 (1941) ("While one many not end with the words of a disputed statute, one certainly begins there.").

The relevant text of § 10(b) provides: "It shall be unlawful for any person . . . [t]o use or employ *in connection with* the purchase or sale of any security . . ., any manipulative or deceptive device or contrivance . . . . ." 15 U.S.C. § 78j(b) (emphasis added). On its face, this language does not limit liability to those who actually trade securities. If Congress had meant to accomplish such a limitation, § 10(b) would provide: "It shall be unlawful for any person to purchase or sell any security by means of any manipulative or deceptive device or contrivance." Instead § 10(b) extends liability to all those who use a fraudulent device "in connection with" the trading of securities.

It is equally clear that there must at least be some "connection" between the fraudulent acts and the trading of securities. *Cf.* 15 U.S.C. § 80b-6 (prohibiting fraud by investment advisors, regardless of whether or not related to securities trading). Thus, while § 10(b) defendants need not actually buy or sell securities, their fraudulent acts must have a "connection" to securities transactions. *Texas Gulf* strikes a reasonable balance, applying liability under § 10(b) to those who make public statements reasonably calculated to influence those who trade securities, whether or not such persons actually trade securities. 401 F.2d at 862.

E&Y makes two text-based counterarguments. First, E&Y argues that the "use or employ" language of § 10(b)

limits liability to those who actually trade securities.[5] It is true that the words "use" and "employ" require some positive action. However, defendants take positive action when they make false statements that they know will reach potential investors, whether or not they also trade securities. *See Anixter v. Home-Stake Prod. Co.*, 77 F.3d 1215, 1226 (10th Cir. 1996) ("Reading the language of § 10(b) and 10b-5 through the lens of *Central Bank of Denver*, we conclude that in order for accountants to 'use or employ' a 'deception' actionable under antifraud law, they must themselves make a false or misleading statement (or omission) that they know or should know will reach potential investors.").

Second, E&Y argues that the use of "the" as opposed to "a" or "any" in the phrase "*the* purchase or sale of any security" also limits liability to those who participate in a particular securities transaction.[6] It is true that the word "the" implies a particularity lacking in the words "a" or "any." However, it does not follow that the defendant's fraud must be connected to a particular securities transaction engaged in by the defendant. This is especially true in light of Congress's insertion of the "in connection with" language.

2. Structural Analysis

The *Central Bank* Court explained that while the text of the statute resolved the case, a structural analysis would lead to the same result. 114 S. Ct. at 1448. *See United States Nat'l*

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[5] Section 10(b) provides: "It shall be unlawful for any person . . . [t]o use or employ, in connection with the purchase or sale of any security . . ., any manipulative or deceptive device or contrivance . . . ." 15 U.S.C. § 78j(b) (emphasis added).

[6] Section § 10(b) provides: "It shall be unlawful for any person . . . [t]o use or employ, in connection with the purchase or sale of any security . . ., any manipulative or deceptive device or contrivance . . ." 15 U.S.C. § 78j(b) (emphasis added).

Bank of Oregon v. Independent Ins. Agents of America, Inc., 508 U.S. 439, 455 (1993) ("Statutory construction 'is a holistic endeavor,' United Savings Ass'n of Texas v. Timbers of Inwood Forest Associates, Ltd., 484 U.S. 365, 371 (1988), and, at a minimum, must account for a statute's full text, language as well as punctuation, structure, and subject matter.").

Here, a structural analysis indicates that securities trading by the defendant is not a prerequisite to liability under § 10(b). At least three securities laws impose liability only where the fraud is part of a securities transaction: § 12(2) of the Securities Act of 1933, 15 U.S.C. § 771(a)(2) (imposing liability on any person who "offers or sells a security" by the use of fraud); § 17(a) of the 1933 Act, 15 U.S.C. § 77q(a) (making it unlawful for any person "in the offer or sale of any securities" to use fraud); and the amended version of § 15 of the 1934 Act, 15 U.S.C. § 78o(c)(1)(A) ("No broker or dealer shall . . . effect any transaction in, or . . .induce or attempt to induce the purchase or sale of, any security" by the use of fraud). In the words of *Texas Gulf*, these laws demonstrate that "when Congress intended that there be a participation in a securities transaction as a prerequisite of a violation, it knew how to make that intention clear." 401 F.2d at 860. Thus, it would ignore the structure of the federal securities laws to read an implied trading requirement into the text of § 10(b).

E&Y makes three structure-based counterarguments. First, E&Y argues that the trading requirement of § 10(a) ought to be read into § 10(b). Section 10(a) prohibits unlawful "short sales" and "stop-loss orders" made "in connection with" securities trading.[7] Obviously, only a

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[7] Section 10(a) makes it unlawful "[t]o effect a short sale, or to use or employ any stop-loss order in connection with the purchase or sale of any security" in violation of any SEC rules. 15 U.S.C. § 78j(a).

defendant who trades securities can be held liable under § 10(a). This, however, is the result of the specific "short sale" and "stop-loss order" requirements of § 10(a), and has nothing to do with the "in connection with" language.

Second, E&Y argues that § 10(b) is a catch-all for §§ 9 and 10(a), and that § 10(b) should therefore by limited by the trading requirement of §§ 9 and 10(a).[8] Both steps of this argument lack merit. The legislative history does indicate that § 10(b) is a catch-all clause. For example, Thomas G. Corcoran, a spokeperson for the Roosevelt Administration, described § 10(b) as a "catch-all" that was necessary to deal with new manipulative devices." *Texas Gulf*, 401 F.2d at 859 (quoting Stock Exchange Regulation, Hearings before the House Committee on Interstate and Foreign Commerce, 73rd Cong., 2d Sess. 115 (1934)). However, it is not clear that § 10(b) is a catch-all for §§ 9 and 10(a) only. Moreover, the fact that §§ 9 and 10(a) both have a trading requirement, 15 U.S.C. §§ 78i, 78j(a), does not necessarily mean that § 10(b) is also so limited. Indeed, the fact that Congress specifically limited §§ 9 and 10(a) to defendants who engaged in securities transactions, but did not so limit § 10(b), is further evidence that reading an implied trading requirement into § 10(b) would be improper.

Third, E&Y argues that *Texas Gulf*'s interpretation of § 10(b) improperly turns § 18 into surplusage. Section 18 makes any party filing false or misleading statements with the SEC liable to any party damaged by reliance on such statements.[9]

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[8] Section 9 prohibits various means of manipulating securities prices. 15 U.S.C. § 78i

[9] Under §18,

> Any persons who shall make or cause to be made any statement in any application, report, or document filed pursuant to this chapter . . . which

It is true that under *Texas Gulf,* many who damage securities traders by filing false statements with the SEC are liable under both § 10(b) and § 18. However, even under Texas Gulf's interpretation of § 10(b), each of these two sections fills a unique niche: on the one hand, § 18 requires proof of reliance which § 10(b) requires proof of scienter which § 18 does not. *See Wachovia Bank & Trust Co., N.A. v. National Student Marketing Corp.*, 650 F.2d 342, 357 (D.C. Cir. 1980) (discussing the differences between § 10(b) and § 18), cert. denied sub nom. *White & Case v. Wachovia Bank & Trust Co.*, N.A., 452 U.S. 954 (1981); Ross v. A.H. Robins Co., 607 F.2d 545, 555-56 (2nd Cir. 1979) (same), cert. denied, 446 U.S. 946 (1980) A defendant has available to it an affirmative defense that it acted in good faith and had no knowledge that its statement was false or misleading. *Musick, Peeler and Garrett v. Employers Ins. of Wausau*, 508 U.S. 286, 296 (1993), (noting § 18 involves defendants who violated securities law with scienter, citing to *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 209, n.28 (1975)). Thus, there is no surplusage problem in extending liability under § 10(b) beyond those who actually trade securities to include those who know their fraudulent activities will affect the market.

3. Policy Analysis

The *Central Bank* Court concluded by rejecting various policy-based arguments raised by the plaintiffs as inconsistent with the Court's textual and structural analysis. 114 S. Ct. at 1450-55. The Court noted the traditional rule that policy considerations "override" the text and structure of a statute

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statement was . . . false or misleading with respect to any material fact, shall be liable to any person . . . who, in reliance upon such statement, shall have purchased or sold a security at a price which was affected by such statement . . . .

15 U.S.C. § 78r(a).

only where necessary to prevent "bizarre" results that Congress obviously did not intend. *Id.* at 1453-54 (citations omitted). This reasoning is fully consistent with the general rule that" 'it is proper for a court to consider . . . policy considerations in construing terms in [the federal securities] Acts.' "*Pinter v. Dahl*, 486 U.S. 622, 653 (1988) (quoting *Landreth Timber Co. v. Landreth*, 471 U.S. 681, 695 n.7 (1985)) (bracket added in *Pinter*). *See also Independent Insurance*, 508 U.S. at 455 (" '[I]n expounding a statute, we must not be guided by a single sentence or member of a sentence, but look to the provisions of the whole law, *and to its object and policy.*' ") (quoting *United States v. Heirs of Boisdore*, 49 U.S. (8 How.) 113, 122 (1849)) (emphasis added).

Congress had "broad remedial goals" when it enacted the depression-era securities laws. *Pinter*, 486 U.S. at 653 (quoting *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 200 (1976)). The Supreme Court has described these goals as follows:

> The 1934 Act was designed to protect investors against manipulation of stock prices. See S. Rep. No. 792, 73d Cong., 2d Sess., 1-5 (1934). Underlying the adoption of extensive disclosure requirements was a legislative philosophy: "There cannot be honest markets without honest publicity. Manipulation and dishonest practices of the market place thrive upon mystery and secrecy." H.R. Rep. No. 1383, 73d Cong., 2d Sess., 11 'fundamental purpose' of the Act as implementing a 'philosophy of full disclosure.' " *Santa Fe Industries, Inc. v. Green*, 430 U.S. 462, 477-78 (1977), quoting *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 186 (1963).

Basic, 485 U.S. at 230. The traders-only rule proposed by E&Y is inconsistent with these goals. It would exempt from the remedial breadth of § 10(b) a broad range of misinformation and market manipulation, so long as the

perpetrators did not buy or sell securities in connection therewith. Yet a party that introduces fraudulent information into the securities market does no less damage to the public because that party did not trade stocks. Congress's goals are better served by giving the "in connection with" language of § 10(b) its natural meaning and imposing liability on all whose false assertions are reasonably calculated to influence the investing public.

4. Summary

The holding of *Texas Gulf* rests soundly upon a textual analysis of § 10(b), a structural analysis of the surrounding securities laws, and a policy analysis of Congress's remedial goals. Accordingly, the methodology of *Central Bank* does not undermine the holding of *Texas Gulf*. *See Adam v. Silicon Valley Bancshares*, 884 F. Supp. 1398, 1402 (N.D. Cal. 1995) ("The court is not persuaded that an abandonment of the *Wessel/Rana Research* construction of the 'in connection with' requirement is justified by the holding of *Central Bank*."); *In re Leslie Fay Companies, Inc.*, 871 F. Supp. 686, 694-97 (S.D.N.Y. 1995) (holding that *Central Bank* did not overturn the traditional interpretation of "in connection with"); *Spear v. Ernst & Young*, Fed. Sec. L. Rep. (CCH) P 98,399 at p. 90,744, 1994 WL 585815 (D.S.C. 1994) ("[T]he court rejects defendants' argument that *Central Bank* represents a radical departure from established precedent regarding the exposure of auditors under Section 10(b)."), *rev'd on other grounds sub nom. In re Policy Management Systems Corp.*, 1995 WL 541623 (4th Cir. Sept. 13, 1995). *See* also *Itoba Ltd. v. LEP Group PLC*, 54 F.3d 118, 123 (2nd Cir. 1995) (following *Texas Gulf* in the post-*Central Bank* era), *cert. denied sub nom. Berkley v. Itoba Ltd.*, ____ U.S. ____, 116 S. Ct. 702 (1996).

D. APPLICATION OF TEXAS GULF TO THE INSTANT FACTS

Under *Texas Gulf* and *Wessel*, plaintiffs' claim survives a motion for judgment on the pleadings. Plaintiffs allege that E&Y produced a fraudulent audit report for CPC, knowing that CPC would include this report in its Form 10-K filed with the SEC. If true, E&Y "made false assertions" 'in a manner reasonably calculated to influence the investing public,' "

Wessel, 437 F.2d at 282 (quoting *Texas Gulf*, 401 F.2d at 862), and thus "in connection with" securities trading in violation of Section 10(b) and Rule 10b-5. *See In re Leslie Fay Companies, Inc.*, 871 F. Supp. 686, 688, 695 (S.D.N.Y. 1995) (refusing to dismiss § 10(b) action against accounting firm that allegedly produced fraudulent audit reports that it knew would be included in its client's Form 10-K).

The fact that E&Y is an outside accounting firm does not foreclose liability under § 10(b) . As *Central Bank* explained, "[a]ny person or entity, including a lawyer, *accountant*, or bank . . . may be liable as a primary violator under 10b-5 . . . ." 114 S. Ct. at 1455 (emphasis added). In *Herman & MacLean v. Huddleston*, 459 U.S. 375 (1983), the Supreme Court upheld a verdict imposing direct § 10(b) liability on "the accounting firm, Herman & MacLean, which had issued an opinion concerning certain financial statements and a *pro forma* balance sheet that were contained in the registration statement and prospectus." *Id.* at 378 (footnote omitted). *See also Knapp v. Ernst & Whinney*, ____ F.3d _____, No. 94056379 (9th Cir. July 23, 1996) (upholding § 10(b) liability for an outside accounting firm that knew its false audit opinions would reach the investing public). *Anixter v. Home-Stak Production Co.*, 77 F.3d 1215, 1227 (10th Cir. 1996) (upholding § 10(b) liability for an outside accounting firm that knew its false audit opinions would reach the investing public). While an outside accounting firm might be blameless where it

had no reason to know that its client would use its audit report to sell securities, or where it instructed its client not to release the report to the public, *Frymire-Brinati v. KPMG Peat Marwick*, 2 F.3d 183, 189-90 (7th Cir. 1993), the instant plaintiffs squarely alleged that E&Y knew that CPC would include its audit opinion in a Form 10-K.

Nor is E&Y protected by the fact that this case involves the dissemination of false information to the investing public by way of an independent audit report contained in a Form 10-K. These forms must be filed with the SEC on an annual basis. *See* 15 U.S.C. § 78m; 17 C.F.R. § 349.310. The stock price of publicly traded companies reflects information contained in Forms 10-K. As the Supreme Court has explained, "[c]orporate financial statements [including Form 10-Ks] are one of the primary sources of information available to guide the decisions of the investing public." *United States v. Arthur Young & Co.*, 465 U.S. 805, 810 & 811 n.5 (1984). Indeed, federal reporting requirements, such as the Form 10-K, exist "to control the accuracy of the financial data available to investors in the securities markets. . . ." *Id.* at 810-11. Fraudulent Forms 10-K thus fall within the ambit of § 10(b). *See Rana*, 8 F.3d at 1358 (liability under § 10(b) extends to "a document such as a press release, annual report, investment prospectus or other such document on which an investor would presumably rely").

III. CONCLUSION

Because an accounting firm acts "in connection with" securities trading when it produces an audit report that it knows its client will include in a Form 10-K, and because *Central Bank* did not overturn this traditional understanding of direct liability under § 10(b), we REVERSE the district court's grant of judgment on the pleadings for E&Y.

REVERSED AND REMANDED.

UNITED STATES DISTRICT COURT
CENTRAL DISTRICT OF CALIFORNIA

SA CV 93-814 AHS (Eex)

DOLLARD McGANN et al.,

Plaintiffs,

v.

ERNST & YOUNG,

Defendant.

ORDER GRANTING DEFENDANT'S MOTION FOR JUDGMENT ON THE PLEADINGS

INTRODUCTION

Plaintiffs filed a single-count Complaint against defendant Ernst & Young, alleging claims under Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 promulgated by the Securities and Exchange Commission (SEC). Defendant moved for Judgment on the Pleadings. After extensive briefing by the parties and oral argument on two occasions, the Court took the motion under advisement. By this Order, the Court grants defendant's motion, concluding that the outside auditor, by submitting its November 30, 1990, audit report to its employer, Community Psychiatric Centers, who in turned included the report with the Form 10-K filing with Securities and Exchange Commission, cannot be held liable as a primary violator of Section 10(b) of the Securities Exchange Act of 1934 (15 U.S.C. § 78j(b)) and SEC Rule 10(b)-5 for having employed *in connection with the purchase or sale of any security* a manipulative or deceptive device or contrivance or

for having made any untrue statement of a material fact or for having engaged in any act or course of business which would operate as a fraud upon any person *in connection with the purchase or sale of any security*.

A lengthy summary of the Complaint enumerates the wrongs cited by plaintiffs, followed by the contentions of the parties, after which a review of some but not all of the cases discussed by the parties, explains the reasons for the conclusion that judgment for defendant is appropriate on this record.

SUMMARY OF THE COMPLAINT

Plaintiffs are parties in a related action referred to as the Community Psychiatric Centers ("CPC") Securities Litigation. The Complaint in that case, SA CV 91-533 AHS, is attached to and incorporated into the Complaint in this suit. The plaintiffs allege that Ernst & Young ("Ernst"), the independent auditor for CPC, violated Section 10b of the Exchange Act and Rule 10b-5 of the Securities and Exchange Commission ("SEC") by engaging in a scheme to defraud by disseminating false public statements about CPC's business and finances. Plaintiffs claim that Ernst engaged in a scheme to defraud investors and, in furtherance of the scheme, knowingly or recklessly issued a false audit opinion in connection with its audit of CPC's 1990 financial statements. Ernst's allegedly false and misleading audit report was included in CPC's Form 10-K filed with the SEC for fiscal year 1990.

Ernst is alleged to have participated directly in and aided and abetted a common scheme and plan to materially inflate and/or to prevent the decline in the price of CPC's stock by falsely portraying, through the dissemination of materially false and misleading public documents, CPC's finances, earnings, management and future business prospects.

Certain paragraphs, some more general than others, allege the wrongs committed by Ernst. In abbreviated fashion, they include:

¶6: Ernst participated by rendering a false auditing opinion to the effect that CPC's publicly disseminated financial statements for the fiscal year ended November 30, 1990, presented fairly, in all material respects, the consolidated financial position of CPC as of November 30, 1990, and the results were in conformity with Generally Accepted Accounting Principles ("GAAP");

¶9: CPC's Form 10-K made misleading statements purporting to explain the reasons for the $37 million in charges to earnings arising from uncollectable receivables announced in September and November of 1991;

¶10: CPC's false statements concealed the true reason for its accounts receivable problem, namely, that its improper billing practices coupled with a completely inadequate system of internal controls had deteriorated the collectibility of accounts receivable where they no longer represented valid claims; these deficiencies had been noted by Ernst as problems as early as 1988;

¶11: A subsequent "special review" conducted by Ernst in October of 1991 displayed the improper performance of the Ernst November 30, 1990, audit, the particulars of which are detailed in ¶¶ 42-44 of the Complaint;

¶13: Ernst is sued as a primary violator and as an aider and abettor of the wrongful conduct of the defendants in the related action, in that Ernst enabled the false and misleading 1990 Financial Statement to be disseminated to the public by rendering its opinion with respect thereto, and failed to promptly disseminate accurate and truthful information with respect to CPC's products, operations, financial condition, and future business prospects or to cause and direct that such

information be disseminated so that the market price of CPC stock would be based on truthful and accurate information;

¶¶ 19-20: Ernst's Report of Independent Auditors, dated January 29, 1991, which was included as page six of CPC's Annual Report and expressly stated that in Ernst's opinion, the financial statements provided by CPC "present fairly, in all material respects, the consolidated results of [CPC's] operations and their cash flow for each of the three years in the period ended November 30, 1990, in conformity with generally accepted accounting principles," was materially false and misleading;

¶23: Without Ernst's certification of the 1990 Financial Statements, CPC's common stock would not have traded at the artificially inflated price levels as alleged in the Complaint;

¶24: Ernst's audit of CPC's November 30, 1990, financial statements failed to comply with Generally Accepted Auditing Standards ("GAAS"). Specifically, Ernst (1) placed an inappropriate and unwarranted degree of reliance on CPC's system of internal controls and utilized an extremely limited, inadequate, and unacceptable sample of transactions; (2) improperly placed an excessive degree of reliance on management's representations and when evidence contradicted the management's representations, Ernst willfully or recklessly ignored or minimized such evidence; (3) failed to obtain competent evidence to support their audit conclusions; and (4) failed to properly address the material misstatements which resulted from CPC's failure to provide adequate bad debt reserves;

¶42-44: The contrary results of Ernst's "special review" of the adequacy of CPC's allowances for uncollectable accounts for the period ending August 31, 1991, noting that significantly higher reserves are required than originally concluded by Ernst for the [illegible]d ending November 30, 1990, constitute an admission by [illegible] of its willful or reckless failure

to conform to GAAS for the audit covering the period ending November 30, 1990;

¶47: By certifying that the 1990 Financial Statements conformed with GAAP, Ernst violated its duties to CPC's investors and directly engaged and participated in and aided and abetted CPC's fraudulent Scheme and Plan;

¶48: By sanctioning CPC's improper accounting with respect to the year-end audit for CPC's 1990 fiscal year, ending November 30, 1990, Ernst enabled CPC to continue such improper accounting in the quarterly financial reports that CPC issued for the first and second quarters of the 1991 fiscal year, ending November 30, 1991, and in other public statements issued by CPC until the end of the class period; thereby, enabling CPC stock to be traded at artificial levels until the end of the class period;

¶49: Had Ernst properly conducted its audit of the 1990 Financial Statements, Ernst would not have rendered certification thereof and CPC's fraudulent Scheme and Plan would not have been succeeded to the extent that it did;

¶51: Ernst knowingly or recklessly issued the materially false and misleading Report of Independent Auditors, dated January 29, 1991, which it knew would appear in CPC's publicly filed financial statements for the fiscal year, ending November 30, 1990;

¶53: Ernst individually and in concert with CPC, directly and indirectly, engaged and participated in and aided and abetted a continuous course of conduct and conspiracy to conceal adverse information regarding the financial outlook of CPC; effectively, Ernst committed fraud on the integrity of the market for CPC's stock by enabling CPC's common stock to be traded at artificially high market prices;

¶55: Plaintiffs paid artificially inflated prices for CPC stock in reliance on the integrity of the market, for, had they

been aware that the market prices had been falsely inflated by defendant's statements and concealments, they would not have purchased CPC's stock at the prices paid or at all.

PROCEDURAL HISTORY OF THIS MOTION

On June 27, 1994, Ernst & Young filed its Motion for Judgment on the Pleadings. Plaintiffs filed opposition on August 12, 1994. Defendant filed its reply on September 2, 1994. The Court heard oral argument on the motion on September 12, 1994, and continued the hearing to November 28, 1994.

Plaintiffs were ordered to submit a supplemental brief no later than October 11, 1994; defendant's supplemental brief was due on November 7, 1994; and, plaintiffs' reply was due on November 21, 1994.

Plaintiffs filed their supplemental brief on October 11, 1994. Defendant filed its supplemental brief on November 7, 1994. Plaintiffs filed their supplemental reply on November 1, 1994. Defendant filed a surreply on November 22, 1994. The Court requested the parties to submit supplemental filings of decisions from any courts of appeals that interpret elements of a Section 10(b) action after Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A., 114 S. Ct. 1439 (1994). The parties were given until December 31, 1994, to submit any further supplemental filings.

The parties undertook to call new decisions to the Court's attention by filings dated March 3, March 9, and March 13, 1995.

In the related case, the Complaint was dismissed on March 20, 1995, based on Central Bank, since severation of any viable claims from the existing complaint containing "aiding and abetting" claims was not possible. On May 9, 1995, plaintiffs filed their Second Amended Complaint in the CPC class action, SA CV 91-533 AHS. In response to the Court's minute order

dated May 10, 1995, the parties agreed by stipulation filed May 22, 1995, that the Second Amended Complaint "shall be deemed incorporated and attached as Exhibit A to the complaint in this action" in place of the First Amended Consolidated Class Action Complaint now attached. A separate section of the CPC Complaint is now devoted to Ernst & Young's role, but the allegations sum up what is currently pleaded in this action.

PARTIES' CONTENTIONS

A. DEFENDANT'S CONTENTIONS

Defendant argues that in light of the Supreme Court's decision in Central Bank, emphasizing the plain wording of the securities statutes, none of plaintiffs' claims can stand. Defendant contends that (1) the Central Bank decision eliminates plaintiffs' secondary liability claims against defendants; (2) plaintiffs, primary liability claim fails because it does not satisfy the "in connection with the purchase or sale" requirement of § 10(b); and (3) defendant is entitled to judgment as to class members' claims pre-dating dissemination of defendant's audit opinion.

In defendant's supplemental brief, defendant states that the narrow issue to be resolved is whether, under Central Bank, the filing of a Form 10-K containing audited financial statements, without more, satisfies § 10(b)'s "in connection with the purchase or sale" requirement regarding an auditor defendant. Defendant argues that plaintiffs have failed to cite a single case from the Ninth Circuit holding that the filing of a Form 10-K containing an accountant's audit opinion, without more, satisfies the "in connection with" requirement regarding an auditor. Defendant asserts that plaintiffs rely on cases interpreting § 10(b)'s reliance requirement, including Basic Inc. v. Levinson, 485 U.S. 224 (1988) and Blackie v. Barrack, 524 F.2d 891 (9th Cir. 1975), cert. denied, 429 U.S. 816 (1976),

but that that these cases do not address the distinct issue regarding the "in connection with" requirement.

Defendant argues that under the Central Bank mandate to adhere to the language of the statute, the mere inclusion of an auditor's opinion in an audit client's Form 10-K routinely filed with the SEC is not an act "in connection with" aftermarket trading of the client's stock. In its supplemental surreply, defendant argues that the additional cases cited by plaintiffs in their reply are not controlling. Plaintiffs err in arguing that In re Software Toolworks Inc. Sec. Litig., 38 F.3d 1078 (9th Cir. 1994), amended, 50 F.3d 615 (9th Cir. 1995), is controlling for two reasons: (1) the decision does not address § 10(b)'s "in connection with" requirement at all but principally addresses the scienter requirement of 10(b); and (2) the decision recognizes potential liability only for documents that were submitted in connection with a public offering.

Defendant rebuffs plaintiffs' criticism of its failure to cite Spear v. Ernst & Young, Fed. Sec. L. Rep. (CCH) ¶ 98,399 (D.S.C. Aug. 15, 1994), as unfounded because (1) this Court requested summaries of cases from only appellate courts; (2) the Spear court mischaracterized defendant's position as requiring a § 10(b) defendant to be a "purchaser" or "seller" of securities; and (3) Spear was incorrectly decided because it takes an expansive approach to the "in connection with" requirement. This approach is inconsistent with Central Bank and cannot be justified by reference to Superintendent of Ins. v. Bankers Life & Casualty Co., 404 U.S. 6 (1971).

B. PLAINTIFFS' CONTENTIONS

Plaintiffs argue that (1) the requirement of a "connection with a purchase or sale of any security" has been satisfied; (2) the Central Bank decision does not overrule settled precedent on conspiracy liability under § 10(b); (3) even if secondary conspiracy liability is not found under § 10(b), the

statute's prohibition of any manipulative or deceptive "device or contrivance" includes schemes to defraud; and (4) defendant is liable for the entire scheme it joined.

Plaintiffs prepared a supplemental brief and case summaries, as requested by the Court. In plaintiffs' supplemental brief, plaintiffs argue that the "two historically seminal 'in connection with' precedents" are SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968), cert. denied, 394 U.S. 976 (1969), and Superintendent of Ins. Pls.' Supp. Opp'n at 3. Both decisions considered the language of the statute and neither supports the narrow reading of "in connection with" stated by defendant.

Plaintiffs argue that the law set forth in Texas Gulf Sulphur and Superintendent of Ins. has not changed and that the standard of liability was reaffirmed by the Supreme Court in Basic Inc. Plaintiffs cite Blackie v. Barrack as the "most often cited Ninth Circuit case on § 10(b)." Pls.' Supp. Opp'n at 5. Plaintiffs claim that the Blackie case is the closest on point. As plaintiffs see it, defendant's preparation of a false auditing opinion that was included in a SEC filing that it knew investors and the market in general would rely upon is sufficient to satisfy the textual requirements of § 10(b) without proof that defendant itself participated in a securities transaction.

Plaintiffs argue that there is no distinction between the participants in an open-market fraud for "in connection with" purposes. They assert that the "company, which authors the textual portion of the Annual Report and 10-K, and the accounting firm, which approves of the financial statement and authors an audit opinion, have both acted 'in connection with' any open-market purchases made in reliance upon those SEC filings." Pls.' Supp. Opp'n at 13.

Plaintiffs' supplemental reply discusses two additional cases, Software Toolworks and Spear, as above noted. Plaintiffs construe Software Toolworks as a holding by the Ninth Circuit that even after Central Bank, accountants may be primarily liable to after-market purchasers for fraudulent statements that are not incorporated in an offering document. Slip op. at 12814-15 & n.3. In fact, plaintiffs conclude that Software Toolworks provides binding Ninth Circuit precedent that "disposes of E&Y's motion." Pls.' Supp. Reply at 2. Plaintiffs refer to Spear where the South Carolina district court rejected this same defendant's argument on the issue.

DISCUSSION

A. STANDARD FOR JUDGMENT ON THE PLEADINGS

Fed. R. Civ. P. 12(c) provides that "after the pleadings are closed but within such time as not to delay the trial, any party may move for judgment on the pleadings." Judgment on the pleadings is appropriate when the moving party establishes that no material issue of fact remains to be resolved and that she is entitled to judgment as a matter of law. Hal Roach Studios Inc. v. Richard Feiner & Co., 896 F.2d 1542, 1550 (9th Cir. 1990). The Court should assume the truthfulness of the material facts alleged in the Complaint. General Conference Corp. of Seventh Day Adventists v. Seventh Day Adventists Congregational Church, 887 F.2d 228, 230 (9th Cir. 1989).

Defendant's motion for judgment on the pleadings is timely because the pleadings are closed and consideration of defendant's motion will not delay trial.

B. GOVERNING AUTHORITIES

Judgment on the pleadings is appropriate as to plaintiffs' secondary liability claims under § 10(b) because the claims for "aiding and abetting" and conspiracy, as pleaded by plaintiffs, have been eliminated by the Central Bank decision. In Central Bank,

the Supreme Court held that a private plaintiff may not maintain an aiding and abetting suit under § 10(b). 114 S. Ct. at 1455.

The Court rejected the policy-based approach to § 10(b) used by lower courts to find aiding and abetting liability. Instead, the scope of § 10(b) must be determined by referring to the statutory text and the express causes of action enacted by Congress in 1934. The text of § 10(b), which makes it "unlawful for any person, directly or indirectly, . . . [t]o use or employ, in connection with the purchase or sale of any security . . ., any manipulative or deceptive device or contrivance," prohibits only the making of a material misstatement (or omission) or the commission of a manipulative act, and does not reach those who aid and abet. The Court stated that the "directly or indirectly" phrase does not encompass aiding and abetting because such liability would extend beyond persons who engage, even indirectly, in prohibited conduct to those who only give some degree of aid to violators. Id. at 1447.

Conspiratorial liability is also alleged against defendant. Compl. at ¶ 53. Again, Central Bank eliminates plaintiffs' claim for conspiracy liability. As with aiding and abetting liability, the absence of any express provision in the statute regarding conspiracy liability should be considered dispositive. The Supreme Court stated that "[i]t is inconsistent with settled methodology in § 10(b) cases to extend liability beyond the scope of conduct prohibited by the statutory text." Central Bank, 114 S. Ct. at 1448.

Furthermore, the Supreme Court stated that control person liability is the only form of secondary liability that is expressly available and other forms of secondary liability are precluded from being recognized:

> Congress did not overlook secondary liability when it created the private rights of action in the 1934 Act. Section 20 of the 1934 Act imposes liability on "controlling persons" -- persons who "contro[l] any

> person liable under any provision of this chapter or of any rule or regulation thereunder." 15 U.S.C. § 78t(a). This suggests that "[w]hen Congress wished to create such [secondary] liability, it had little trouble doing so." Pinter v. Dahl, [486 U.S. 622, 650 (1988)]; cf. Touche Ross & Co. v. Redington, 442 U.S. 560, 572 (1979) ("Obviously, then, when Congress wished to provide a private damages remedy, it knew how to do so and did so expressly"); see also Fischel, [Secondary Liability under Section 10(b) of the Securities Act of 1934, 69 Cal. L. Rev. 80], at 96-98 [(1981)]. Aiding and abetting is "a method by which courts create secondary liability" in persons other than the violator of the statute. Pinter v. Dahl, supra, 486 U.S. at 648, n. 24. The fact that Congress chose to impose some forms of secondary liability, but not others, indicates a deliberate congressional choice with which the courts should not interfere.

Central Bank, 114 S. Ct. at 1451-52.

The United States District Court for the Northern District of California has held that the Central Bank decision eliminates conspiracy liability under § 10(b). See In re Ross Sys. Sec. Litig., No. C-94-0017-DLJ (N.D. Cal. July 21, 1994); In re Syntex Corp. Sec. Litig., No. 92-20548 SW (N.D. Cal. May 27, 1994). In Ross, the district court dismissed § 10(b) conspiracy claims with prejudice in light of the Central Bank decision, noting:

> Like aiding and abetting, conspiracy is a form of vicarious liability. Both are generally described in securities law as forms of "secondary" liability. A member of a conspiracy to violate § 10(b) may, of course, be a party who commits a manipulative and deceptive act and is therefore liable as a primary violator. In such a case, a conspiracy claim is simply duplicative pleading of § 10(b) liability. If, however, the member of the conspiracy is not a primary violator, that party is not the violator of the statute and

> may be held liable only in a theory of secondary liability. Just as "the text of § 10(b) does not prohibit aiding and abetting,"[Central Bank, 114 S. Ct.] at 1452, it does not prohibit conspiring with primary violators. Both aiders and abettors and conspirators fall into the conceptual category of those who are "giving aid" to primary violators. It is apparent, then, that the Central Bank rationale that prohibits implied aiding and abetting liability is applicable to implied conspiratorial liability and leads to the inevitable conclusion that conspiratorial liability for § 10(b) does not survive Central Bank.

Slip op. at 8-9.

The remaining question is whether the Complaint states a case of primary liability. The claim must fall because, taken as true, it does not satisfy the "in connection with" requirement of § 10(b). The Central Bank decision held that the scope of prohibited conduct under § 10(b) must be determined by looking at the text of the statute and to the language of the express liability provisions of the 1934 Act. So, too, must plaintiffs' primary liability claim be analyzed by looking to the text. What Ernst did cannot be converted into making a false statement or committing a manipulative act "in connection with" the sale or purchase of securities.

Plaintiffs cite Wessel v. Buhler, 437 F.2d 279 (9th Cir. 1971), and Texas Gulf Sulphur as precedents interpreting the "in connection with" requirement in the context of an open market case. These decisions were, however, based on the courts' evaluation of the policies and purposes regarding the 1934 Act with no discussion of the express liability provisions of the Act and limited consideration of the language of § 10(b).

Plaintiffs also rely on Basic Inc. and Blackie, but these cases are not necessarily dispositive of the issue at hand. Both cases discuss § 10(b)'s reliance or causation element; they do not focus on the separate "in connection with" requirement. The two

concepts are distinct. S.E.C. v. Rand Research Inc., 8 F.3d 1358, 1361 (9th Cir. 1993). In addition, Basic addresses misrepresentations by a company, an issuer of stock, not an accountant or attorney and not an SEC filing.

Plaintiffs cite Software Toolworks for the proposition that the Ninth Circuit has held that alleged misrepresentations in letters to the SEC constitute deceptive conduct "in connection with" the sale of securities, and, as such, the allegations here state a primary cause of action under § 10(b). In Software Toolworks, plaintiffs alleged that Deloitte & Touche, the company's auditor, violated § 10(b) by participating in drafting two letters that the corporation sent to the SEC, which letters contained false and misleading statements regarding the company's lack of financial data and misleadingly described the nature of certain contracts. Software Toolworks, 38 F.3d at 1090, amended, 50 F.3d at 628.

The Court of Appeals made the following observation about what was at issue in Software Toolworks:

> The district court analyzed this issue in terms whether Deloitte was liable for "aiding and abetting" Toolworks' primary violation of section 10 (b). . . . After the district court issued its opinion, however, the Supreme Court concluded that aiding and abetting liability does not exist under section 10 (b). . . . Despite Central Bank, we nevertheless consider this issue because the plaintiffs' complaint clearly alleges that Deloitte is primarily liable under section 10 (b) for the SEC letters. In fact, the July 1 SEC letter stated that it "was prepared after extensive review and discussions with . . . Deloitte" and actually referred the SEC to two Deloitte partners for further information. . . . Similarly, the plaintiffs presented evidence that Deloitte played a significant role in drafting and editing the July 4 SEC letter. . . . This evidence is sufficient to sustain a primary cause of action under

section 10 (b) and, as a result, Central Bank does not absolve Deloitte on these issues.

38 F.3d at 1090, amended, 50 F.3d at 628 n.3 (9th Cir. 1995).

The Software Toolworks court found that there was a triable issue as to whether Deloitte had scienter with respect to the letters and reversed the grant of summary judgment. The Ninth Circuit did not discuss the "in connection with" language or the impact of the Central Bank decision on the interpretation of that language. Indeed, as plaintiffs have continually pointed out, the Central Bank decision itself also did not discuss the statutory phrase at issue. The court in Software Toolworks cited its decision in In re Worlds of Wonder Sec. Litig., 1994 U.S. App. LEXIS 25471 (9th Cir. Sept. 15, 1994), and did observe that "the mere publication of inaccurate accounting figures, or a failure to follow GAAP, without more, does not establish scienter." 38 F.3d at 1089, amended, 50 F.3d at 627. These allegations are oft-repeated, of course, against Ernst in this action.

Although the South Carolina district court in Spear took an expansive approach in reviewing the "in connection with" language of § 10(b), this court must respectfully part company, since the decision's rationale is undermined by the Supreme Court's decision in Central Bank.

There is no question that plaintiffs' position enjoys precedential support, as does defendant's. Several recent district court opinions lend support to plaintiffs' reading of Section 10(b) (see cases cited in Plaintiff's Response, filed March 9, 1995). The purpose of the periodic reporting requirements is "for the proper protection of investors and to insure fair dealing" in the security and "in the public interest or for the protection of investors." 15 U.S.C. § 78m(a), § 78o(d). Moreover, pre-Central Bank decisions contain the broad language plaintiffs attribute to their claim here. On the other hand, many of plaintiffs' precedents antedate Central Bank and the viability of their holdings must be

questioned; e.g., In re Ames Department Stores Inc. Stock Litigation, 991 F.2d 953 (2nd Cir. 1993).

Defendant's issuance of an audit report, as set out in the pleadings before the court, included in the periodic disclosure filing, not in any offering document, will not entitle plaintiffs to relief, since the report cannot be considered as having been made "in connection with" the purchase or sale of a security. In re Financial Corp. of America Shareholder Lit., 796 F.2d 1126, 1130 (9th Cir. 1986).

CONCLUSION

Accordingly, and for the foregoing reasons, the Court grants defendant's Motion for Judgment on the Pleadings.

IT IS SO ORDERED.

IT IS FURTHER ORDERED that the Clerk shall serve a copy of this Order on counsel for all parties in this action.

Dated: May 30, 1995.

ALICEMARIE H. STOTLER
UNITED STATES DISTRICT JUDGE

SECTION 9

15 U.S.C. § 78i Manipulation of security prices

TRANSACTIONS RELATING TO PURCHASE OR SALE OF SECURITY

(a) It shall be unlawful for any person, directly or indirectly, by the use of the mails or any means or instrumentality of interstate commerce, or of any facility of any national securities exchange, or for any member of a national securities exchange --

(1) For the purpose of creating a false or misleading appearance of active trading in any security registered on a national securities exchange, or a false or misleading appearance with respect to the market for any such security, (A) to effect any transaction in such security which involves no change in the beneficial ownership thereof, or (B) to enter an order or orders for the purchase of such security with the knowledge that an order or orders of substantially the same size, at substantially the same time, and at substantially the same price, for the sale of such security, has been or will be entered by or for the same or different parties, or (C) to enter any order or orders for the sale of any such security with the knowledge that an order or orders of substantially the same size, at substantially the same time, and at substantially the same price, for the purchase of such security, has been or will be entered by or for the same or different parties.

(2) To effect, alone or with one or more other persons, a series of transactions in any security registered on a national securities exchange creating actual or apparent active trading in such security or raising or depressing the price of such security, for the purpose of inducing the purchase or sale of such security by others.

(3) If a dealer or broker, or other person selling or offering for sale or purchasing or offering to purchase the security, to induce the purchase or sale of any security registered on a national securities exchange by the circulation or dissemination in the ordinary course of business of information to the effect that the price of any security will or is likely to rise or fall because of market operations of any one or more persons conducted for the purpose of raising or depressing the prices of such security.

(4) If a dealer or broker, or other person selling or offering for sale or purchasing or offering to purchase the security, to make, regarding any security registered on a national securities exchange, for the purpose of inducing the purchase or sale of such security, any statement which was at the time and in the light of the circumstances under which it was made, false or misleading with respect to any material fact, and which he knew or had reasonable ground to believe was so false or misleading.

(5) For a consideration, received directly or indirectly from a dealer or broker, or other person selling or offering for sale or purchasing or offering to purchase the security, to induce the purchase or sale of any security registered on a national securities exchange by the circulation or dissemination of information to the effect that the price of any such security will or is likely to rise or fall because of the market operations of any one or more persons conducted for the purpose of raising or depressing the price of such security.

(6) To effect either alone or with one or more other persons any series of transactions for the purchase and/or sale of any security registered on a national securities exchange for the purpose of pegging, fixing, or stabilizing the price of such security in contravention of

such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

TRANSACTIONS RELATING TO PUTS, CALLS, STRADDLES, OR OPTIONS

(b) It shall be unlawful for any person to effect, by use of any facility of a national securities exchange, in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors --

(1) any transaction in connection with any security whereby any party to such transaction acquires any put, call, straddle, or other option or privilege of buying the security from or selling the security to another without being bound to do so; or

(2) any transaction in connection with any security with relation to which he has, directly or indirectly, any interest in any such put, call, straddle, option, or privilege; or

(3) any transaction in any security for the account of any person who he has reason to believe has, and who actually has, directly or indirectly, any interest in any such put, call, straddle, option, or privilege with relation to such security.

ENDORSEMENT OR GUARANTEE OF PUTS, CALL, STRADDLES, OR OPTIONS

(c) It shall be unlawful for any member of a national securities exchange directly or indirectly to endorse or guarantee the performance of any put, call, straddle, option, or privilege in relation to any security registered on a national securities exchange, in contravention of such rules and regulations as the Commission may prescribe as necessary or

appropriate in the public interest or for the protection of investors.

REGISTERED WARRANT, RIGHT, OR CONVERTIBLE SECURITY NOT INCLUDED IN "PUT," "CALL," "STRADDLE," OR "OPTION"

(d) The terms "put", "call", "straddle", "option", or "privilege" as used in this section shall not include any registered warrant, right, or convertible security.

PERSONS LIABLE; SUITS AT LAW OR IN EQUITY

(e) Any person who willfully participates in any act or transaction in violation of subsections (a), (b), or (c) of this section, shall be liable to any person who shall purchase or sell any security at a price which was affected by such act or transaction, and the person so injured may sue in law or in equity in any court of competent jurisdiction to recover the damages sustained as a result of any such act or transaction. In any such suit the court may, in its discretion, require an undertaking for the payment of the costs of such suit, and assess reasonable costs, including reasonable attorneys' fees, against either party litigant. Every person who becomes liable to make any payment under this subsection may recover contribution as in cases of contract from any person who, if joined in the original suit, would have been liable to make the same payment. No action shall be maintained to enforce any liability created under this section, unless brought within one year after the discovery of the facts constituting the violation and within three years after such violation.

SECTION NOT APPLICABLE TO EXEMPTED SECURITIES

(f) The provisions of this section shall not apply to an exempted security.

SECTION 10

15 U.S.C. § 78j. Manipulative and deceptive devices

It shall be unlawful for any person, directly or indirectly, by the us of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange --

(a) To effect a short sale, or to sue or employ any stop-loss order in connection with the purchase or sale, of any security registered on a national securities exchange, in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

SECTION 18

15 U.S.C. § 78r. Liability for misleading statements

PERSONS LIABLE; PERSONS ENTITLED TO RECOVER; DEFENSE OF GOOD FAITH; SUIT AT LAW OR IN EQUITY; COSTS, ETC.

(a) Any person who shall make or cause to be made any statement in any application, report, or document filed pursuant to this chapter or any rule or regulation thereunder or any undertaking contained in a registration statement as provided in subsection (d) of section 78o of this title, which statement was at the time and in the light of the circumstances under which it was made false or misleading with respect to any material fact, shall be liable to any person (not knowing that such statement was false or misleading) who, in reliance upon such statement, shall have purchase or sold a security at a price which was affected by such statement, for damages caused by such reliance, unless the person sued shall prove that he acted in good faith and had no knowledge that such statement was false or misleading. A person seeking to enforce such liability may sue at law or in equity in any court of competent jurisdiction. In any such suit the court may, in is discretion, require an undertaking for the payment of the costs of such suit, and assess reasonable costs, including reasonable attorneys' fees, against either party litigant.

CONTRIBUTION

(b) Every person who becomes liable to make payment under this section may recover contribution as in cases of contract from any person who, if joined in the original suit, would have been liable to make the same payment.

PERIOD OF LIMITATIONS

(c) No action shall be maintained to enforce any liability created under this section unless brought within one year after

the discovery of the facts constituting the cause of action and within three years after such cause of action accrued.

Code of Federal Regulations, Title 17 (1989)

§ 240.10b-5 Employment of manipulative and deceptive devices

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

(a) To employ any device, scheme, or artifice to defraud,

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

[EXCERPTS FROM COMPLAINT AND EXHIBIT A THERETO CONTAINED IN EXCERPTS OF NINTH CIRCUIT APPELLATE RECORD]

UNITED STATES DISTRICT COURT
CENTRAL DISTRICT OF CALIFORNIA

Civ. No. CV 93-3712-WMB (GHKx)

DOLLARD McGANN, BARRY L. BRAGGER, PETER GERSHON, STEVEN COOPERMAN, WILLIAM S. ATHERTON, IRVING SCHER, MICHAEL PATITUCCI, JR., J. FLOYD JOHNSON, SCHULMAN, ROGERS, GANDAL, PORDY & ECKER, P.A., JUDITH ISAACS, VIRGINIA DAVIS, JULIE SIROTA KARCHIN, CHARLES FARBER and STEPHEN ADLER, On Behalf of Themselves And All Others Similarly Situated,

Plaintiffs,

vs.

ERNST & Y0UNG,

Defendant.

CLASS ACTION COMPLAINT FOR VIOLATION OF THE FEDERAL SECURITIES LAWS

[FILED UNDER SEAL PURSUANT TO ORDER OF THE COURT]

Plaintiffs, by their undersigned attorneys, for their complaint against defendant, allege upon information and belief, except as to the allegations of ¶12 which are alleged upon personal knowledge, as follows:

* * *

NATURE OF THE ACTION

4. This is a securities class action on behalf of all persons who purchased the common stock of Community Psychiatric Centers ("CPC" or the "Company") between September 4, 1990 and November 4, 1991 (the "Class Period"). CPC operates a chain of acute psychiatric hospitals in the United States and the United Kingdom. Its common stock is actively traded in an efficient market on the New York Stock Exchange. During the Class Period the defendant, Ernst & Young, directly engaged and participated in and aided and abetted a common scheme and plan to materially inflate and/or to prevent the decline in the price of CPC's common stock during the Class Period by falsely portraying, through the dissemination of materially false and misleading public documents, the Company's finances, earnings, management and future business prospects ("the Scheme and Plan").

5. The Company and certain of its directors and officers named as defendants in a related class action currently pending in this court, In re Community Psychiatric Centers Securities Litigation, Master File No. SACV-91-533-AHS (RWX) (the "Related, Action"), engaged in the Scheme and Plan as alleged in the amended consolidated complaint therein, a copy of which is annexed hereto as Exhibit "A" (the "Related Complaint"). Pursuant to the Scheme and Plan, the defendants in the Related Action caused or permitted CPC to issue falsely positive public statements in press release and public documents, including reports filed with the SEC, regarding CPC, its finances, management, earnings and future business prospects to the effect that CPC was a successful, well-managed and well-controlled company. During the Class Period, CPC touted its record of 20 years uninterrupted growth in quarterly earnings, and published forecasts that it would earn between $2.07-$2.10 per share in fiscal 1991. CPC

officials publicly stated "there is no bad news we see coming." By making and/or conspiring to make such statements, the defendants in the Related Action further engage in acts, practices and devices which operated as a scheme or artifice to defraud plaintiffs and the members of the Class as herein defined. The defendants in the Related Action knew and intended that the representations, omissions and wrongful actions would artificially inflate and/or prevent the decline in price of CPC stock during the Class Period, thereby allowing certain CPC insiders to reap over $14 million in proceeds from insider sales of over 507,000 shares of CPC stock, prior to the revelations of September 27, 1991, and November 4, 1991 detailed below.

6. During the Class Period, Ernst & Young was CPC's outside auditor and directly engaged and participated in and aided and abetted the Scheme and Plan by intentionally or recklessly rendering a false auditing opinion to the effect that CPC's publicly disseminated financial statements for the fiscal year ended November 30, 1990 presented fairly, in all material respects, the consolidated financial position of CPC as of November 30, 1990 and the results of operations and cash flow for the fiscal year ending November 30, 1990, were in conformity with Generally Accepted Accounting Principles ("GAAP").

* * *

[EXHIBIT A TO COMPLAINT]

UNITED STATES DISTRICT COURT
CENTRAL DISTRICT OF CALIFORNIA

Master File No. SACV-91-533-AHS (RWRx)

DOLLARD McGANN; BARRY L. BRAGGER; PETER GERSHON; STEVEN COOPERMAN; WILLIAM S. ATHERTON; IRVING SCHER; MICHAEL PATITUCCI, JR.; J. FLOYD JOHNSON; SCHULMAN, ROGERS, GANDAL, PORDY & ECKER, P.A.; JUDITH ISAACS; VIRGINIA DAVIS; JULIE SIROTA KARCHIN; CHARLES FARBER and STEPHEN ADLER, On Behalf of Themselves and All Others Similarly Situated,

Plaintiffs,

vs.

COMMUNITY PSYCHIATRIC CENTERS, JAMES W. CONTE, RICHARD L. CONTE, ROBERT L. GREEN, JAMES P. SMITH and LOREN B. SHOOK,

Defendants.

FIRST AMENDED CONSOLIDATED CLASS ACTION COMPLAINT FOR VIOLATION OF THE FEDERAL SECURITIES LAWS

Plaintiffs, by their undersigned attorneys, for their complaint against defendants, allege upon information and belief, except as to the allegations of ¶7 which are alleged upon personal knowledge as follows:

* * *

NATURE OF THE ACTION

4. This is a securities class action on behalf of all persons, other than defendants, who purchased the common stock of Community Psychiatric Centers ("CPC" or the "Company") between September 4, 1990 and November 4, 1991 (the "Class Period"). During the Class Period, the defendants issued, caused or permitted CPC and certain of its directors and officers to issue positive public statements in press releases and in other documents, including reports filed with the SEC regarding CPC, its finances, management, earnings and future business prospects to the effect that CPC was a successful, well-managed and well-controlled company that would continue to report growth of earnings per share of at least 15% per year. During the Class Period CPC touted its record of 20 years uninterrupted growth in quarterly earnings, and published forecasts that it would earn between $2.07-$2.10 per share in fiscal 1991. CPC officials publicly stated "there is no bad news we see coming." By making and/or conspiring to make such statements, defendants further engaged in acts, practices and devices which operated as a scheme or artifice to defraud plaintiffs and the members of the Class as herein defined. Defendants knew and intended that these representations, omissions and wrongful actions would artificially inflate and/or prevent the decline in value of CPC stock during the Class Period, thereby allowing certain CPC insiders to reap over $14 million in proceeds from insider sales of over 507,000 shares of CPC stock and likely more thereafter, prior to the revelations of September 27, 1991, and November 4, 1991 detailed below.

5. On September 27, 1991, the Company announced a $23 million charge against earnings for bad debts and revealed that income for the third quarter of fiscal 1991 would be only $0.01 per share, compared to market expectations of $0.48 to

$0.50 per share. That day, the price of CPC stock fell more than $6.50 -- an almost 27% decline in one day -- to $17.25 per share. On November 4, 1991, the Company announced that it would take an additional charge of $14 million in the fourth quarter to cover anticipated losses in accounts receivable. As a result of these revelations, CPC stock, which sold for as much as $40 per share during the Class Period, fell to $12.50 per share on November 4, 1991.

6. As set forth below, while in possession of the material adverse facts set forth herein, the individual defendants sold substantial amounts of CPC common stock during the Class Period, with knowledge that CPC was experiencing the undisclosed problems set forth in ¶46 which would adversely affect CPC's net income.

* * *

BACKGROUND ALLEGATIONS

24. Prior to and throughout the Class Period, CPC and the Individual Defendants, assisted by certain professional advisors presently unknown to plaintiffs, were in continuous telephonic and personal contact with stock market professionals, analysts, money managers and similar members of the professional investment community, in part through the activities of various officers, directors and employees of defendants who periodically provided information to securities analysts in order to promote the Company and purportedly inform the investment community of the current status and near- and long-term prospects of the Company. Defendants also caused the Company to issue a series of press releases to the news media and the investment community, as well as to plaintiffs and the members of the Class. In these presentations and in other formal and informal contacts, CPC and the Individual Defendants stated, indicated and confirmed to

analysts, other stock market professionals and the investment community that CPC's business was strong and the Company would report continued earnings growth of at least 15% in fiscal 1991.

THE FALSE AND MISLEADING STATEMENTS

25. In an article published in Barron's on September 4, 1990, defendant J. Conte stated that CPC would earn $2.10 per share in fiscal 1991. This statement was false and misleading in failing to disclose the material adverse facts set forth in ¶46. Following publication of this forecast defendant R. Conte sold 20,793 shares of CPC stock in the open market at $26 per share and defendant Shook sold 22,540 shares at $26 per share.

26. In a press release disseminated to the market on or about September 7, 1990, CPC announced its financial results for the third quarter of fiscal 1990, ended August 31, 1990. The Company reported that revenues for the quarter were $94.8 million, compared to $80.2 million in the third quarter of fiscal 1989; and that net income was $19.7 million or 50.43 per share, compared to $16.9 million or $0.37 per share in the prior year's period. However, these statements were false and misleading in failing to disclose the material adverse facts set forth in ¶ .

27. On October 16, 1990, the Company filed with the SEC and issued its report on Form 10-Q for the third fiscal quarter, ended August 31, 1990. The Form 10-Q, which included CPC's unaudited financial statements for the period, reiterated the information in the September 27, 1990, press release and was signed by defendant R. Conte. These statements were false and misleading for failure to disclose the adverse facts specified in ¶46.

28. In a press release disseminated to the market on or about December 10, 1990, CPC announced that hospital

admissions and total patient days significantly increased in the fourth quarter, ended November 30, 1990, a favorable indicator that CPC would report strong earnings growth when its financial results for the fiscal year ended November 30, 1990 were reported at the end of January 1991.

29. Following this announcement, on December 10 and 11, 1990, Company officials met with analysts and other market professionals in New York and made favorable comments about the Company's future prospects and affirmed that CPC would earn $2.10 per share in fiscal 1991.

30. On December 13, 1990, following CPC's favorable December 10 announcement of fourth quarter patient data and the favorable comments made by CPC officials to analysts in New York on December 10 and 11, defendant R. Conte sold 76,617 shares of CPC stock and defendant Shook sold 120,141 shares for a price of $29.38 per share. Defendant J. Conte publicly denied that the insider sales were indicative of any problems at CPC. He represented to the Los Angeles Times on January 17, 1991: "There is no bad news we see coming."

31. In a press release disseminated to the financial community on or about January 29, 1991, CPC announced its financial results for the fourth quarter and fiscal year ended November 30, 1990. The Company represented that for the year revenues were $381.79 million compared to $330.72 million in the prior year; and that net income for the year was $83.21 million or $1.80 per share, compared to $71.96 million or $1.56 per share, earned in fiscal 1989. For the quarter, CPC reported that revenues were $99.6 million, compared to $80.1 million in the fourth quarter of fiscal 1989 and that earnings were $20.7 million or $0.45 per share, compared to $16.4 million or $0.36 per share in the prior year's period. These statements were false and misleading due to the failure to disclose the material adverse facts specified in ¶46.

32. On or about February 12, 1991, the Company filed with the SEC and issued its report on Form 10-K and Annual Report to Shareholders for the fiscal year ended November 30, 1990. The Form 10-K, which contained CPC's audited financial statements for the year, reiterated the financial results reported in the January 17, 1991 press release and was signed by defendants J. Conte and R. Conte, among others. These statements were each false and misleading in failing to disclose the material adverse facts specified in ¶46.

33. The Annual Report contained a letter to shareholders signed by defendants J. Conte and R. Conte which contained the following representations:

> 1990 was a good year for Community Psychiatric Centers. Earnings per share from continuing operations amounted to $1.80, up from $1.56, a 15% gain. As stated in prior reports our goal is earnings per share growth of 15% or better each year and each quarter. The Company has achieved or exceeded this goal for 21 consecutive years and 83 out of 86 quarters. These earnings gains have occurred while we have consistently maintained a policy of charging at the community average or less for superior patient care services in the trade areas in which we operate psychiatric hospitals.
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> * * *
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> Much has been written, rumored or said during the past twelve months about alleged problems or troubles facing the U.S. psychiatric industry. Oftentimes, the problems of specific companies have been overgeneralized as problems for all companies in our industry, including Community Psychiatric Centers. In short, a lot of confusion and debate has been generated as to whether the entire psychiatric hospital industry is in trouble or whether it is just a few companies.

Our industry is undergoing a "shake-out" period wherein some of our competitors will fail or be forced to substantially reorganize for a number of complex reasons including declining utilization, high or uncontrollable costs, inability to service highly leveraged debt, media and public backlash against questionable advertising, changeover in management direction, mercenary payments to those who might refer patients to them, and high corporate overhead.

We believe CPC is uniquely positioned to take advantage of both its own strengths and the current problems of our competitors. For over twenty years we have managed to control our costs of operation while being able to keep our prices lower than our competitors. Low corporate overhead, virtually no advertising, extremely limited debt service and close corporate monitoring of costs in our hospitals have all contributed to our ability to charge less than others while achieving higher profit margins.

* * *

The Company maintains a conservative financial position with adequate resources to carry out its expansion plans and make significant acquisitions in the medical services field if attractive opportunities arise. The ratio of equity to debt on our balance sheet is the strongest in the hospital management industry. As financial conditions of some of our competitors become further aggravated we expect that the number of acquisition potentials may increase. We are well positioned to prosper in an increasingly more difficult industry.

The letter concluded: "1991 promises to be another good year." These statements were false and misleading in failing to disclose the material facts specified in ¶46.

(* * *) denied reports which suggested that CPC was paying off "brokers" for referrals of and otherwise improperly recruiting patients from Canadian Indian reservations for treatment in its psychiatric hospitals to obtain benefits provided by government insurance. Defendant R. Conte told the San Francisco Chronicle CPC was the "good guy" when it came to Canadian treatment, that the Canadian patients were referred by physicians and that the Canadian patients represented well below 1% of the firm's patients on any given day. These statements were false and misleading in failing to disclose the material adverse facts set forth in ¶46.

35. In a press release disseminated to the market on March 28, 1991, CPC announced its financial results for the first quarter of fiscal 1991, ended February 28, 1991. The Company reported that revenues for the quarter grew to $103 million, compared to $84.6 million in the prior year's period; and that net income was $21.1 million or $0.46 per share, compared to $18.8 million or $0.41 per share in the prior year's period. However, these statements were false and misleading in failing to disclose the material adverse facts set forth in ¶46.

36. On April 15, 1991, the Company filed with the SEC and issued its report on Form 10-Q for the first quarter, ended February 28, 1991. The Form 10-Q, which included CPC's unaudited financial statements for the quarter, reiterated the information in the March 28, 1991 press release and was signed by defendant R. Conte. These statements were materially false and misleading due to the failure to disclose the material adverse facts specified in ¶46.

37. In late April 1991, CPC publicly denied reports that it was using "aggressive revenue or expense recognition policies" to inflate its financial results. In an article published in the Wall Street Journal on April 24, 1991, a spokeswoman for the Company said that while the Company had receivables

equaling 110 days sales, the problem was concentrated in California and that two full-time employees had been sent there to work on collection. She also denied that CPC had a problem relating to the recruitment of Canadian patients, asserting that Canadian patients accounted for less than 1% of the patient population of CPC hospitals in fiscal 1990. These statements were false and materially misleading in failing to disclose the material adverse facts set forth in ¶46.

38. In early May 1991, Defendant R. Conte made a presentation about CPC to financial analysts at the Alex. Brown & Sons, Inc. annual health care seminar in which he stated:

> Since the Company's creation in 1969, we've had steady orderly consistent growth of 15% or better in 83 of 87 quarters in 21 out of 21 years. We expect earnings growth to continue and possibly accelerate in future years. . . .
>
> [I]n our hospitals division we charge less than others but we earn more than others. Pre-tax operating margins have historically been close to 40%. In the past three or four years, they've been more in 34%, 35%, 36% range. We emphasize, we run open staff hospitals as opposed to closed staff models. The doctors prescribe treatment plans for our patients and it's up to us to provide the facilities and personnel and the programs to carry out their orders. The doctors use our facilities because they want to, not because they are paid to do so or because they have to do so. . . .
>
> [T]he relevant unit of sale in our business is patient days. Utilization data was excellent in the fourth quarter of 1990 and continues into 1991. During the first quarter of 1991, patient days increased 12.2% while admissions were up 17.2%. I think this needs to be contrasted off and with some of the other players in the industry who have been

> showing negative numbers for the past couple of years. We think we're out of what we call the media backlash in 1990. A lot of you that have been following the stock may recall that our patient days went negative in the first and second quarters of 1990. We got that turned around during the summer where they went flat. They were up nicely in the fourth quarter, and as I said, continue into this year progressing nicely. . . . [W]e're still looking at a 15% or better growth on earnings for the year [fiscal 1991] which ought to put us in the $2.07 range.

These statements were false and misleading in failing to disclose the material adverse facts specified in ¶46.

39. In a press release disseminated to the financial community on July 1, 1991, CPC announced its financial results for the second quarter of fiscal 1991, ended May 31, 1991. The Company represented that revenues for the quarter were $117.7 million compared to $102.6 million in the second quarter of fiscal 1990; and that earnings were $26.7 million or $0.58 per share, compared to $23.9 million or $0.52 per share in the prior year's period. The press release also stated:

> The CPC Managed Care Division is experiencing encouraging sales results with higher than expected proposal activity. To date, two accounts, both of which are California based managed care companies have signed exclusive or case rate arrangements with CPC. The rollout of these products will start in July with completion of account changeover by December 31st. The accounts potentially represent several thousand patient days on an annualized basis. Several other proposals are currently being negotiated into final contract form.

These statements were materially false and misleading in failing to disclose the material adverse facts specified in ¶46.

40. On July 12, 1991, the Company filed with the SEC and issued its report on Form 10-Q for the second quarter ended May 31, 1991. The Form 10-Q, which contained CPC's unaudited financial statements for the quarter, reiterated the information in the July 1, 1991 press release and was signed by defendant R. Conte. These statements were materially false and misleading due to the failure to disclose the material adverse facts specified in ¶46.

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